



CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

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

December 17, 2002

Maze & Associates' Audit of the City of Palo Alto's Financial Statements as of June 30, 2002 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, 2002. 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, 2002.

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

- Memorandum on Internal Control Structure for the year ended June 30, 2002 (the "management letter") – Attachment A
- Independent Auditor's Report on Compliance with the Proposition 111 2001-02 Appropriation Limit Increment (the "Gann limit letter") – Attachment B
- Public Improvement Corporation Component Unit Financial Statements for the year ended June 30, 2002 – Attachment C
- Regional Water Quality Control Plant Financial Statements for the year ended June 30, 2002 – Attachment D
- Cable Cooperative Franchise Statements of Franchise Revenues and Expenditures for the years ended December 31, 2001 and 2000 – Attachment E
- Bicycle/Pedestrian Projects Financial Statements for the years ended June 30, 2002 and 2001 – Attachment F

Cory Biggs from Maze & Associates will be available at the December 17th Finance Committee meeting to answer questions. I would like to express appreciation to Maze & Associates for their insight and thoroughness in conducting the audit, and to Trudy Eikenberry and her staff in the Administrative Services Department for their hard work in ensuring a good audit for the City of Palo Alto.

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, 2002**

MAZE & ASSOCIATES

October 31, 2002

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

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

As part of our audit of the financial statements of the City of Palo Alto for the year ended June 30, 2002, 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.

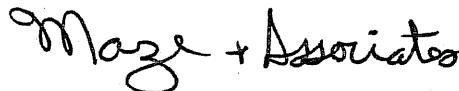
A material weakness is a significant deficiency in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited 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

GASB 34 Implementation

Fiscal 2001-2002 was the first year of adopting the provisions of and implementing *Governmental Accounting Standards Board Statement #34, Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. This major overhaul and restructuring of the City's and Public Improvement Corporation's financial statements was the major emphasis of the audit this year. Staff provided us with expanded data and analysis to complete the required statements, disclosures and entries needed to complete the reports. We assisted staff in certain areas such as interpreting and applying in practice the requirements of this new statement. Overall the implementation was successful with few problems. Staff took strong interest in preparing the data and understanding the requirements. As with any change this significant there are a few areas which can be improved. Listed below are the key areas of expanded work covered under GASB 34 along with some suggestions for improvement with the next year's close.

- Capital Asset Accounting is the reporting and disclosure of governmental assets formerly included as general fixed assets, the addition of the estimated value of infrastructure assets acquired in prior years and the current year, and the calculation and recording of depreciation expense in the current year and the accumulated effect of prior years.

Staff had the majority of this data ready for our audit and had a thorough understanding of the requirements of GASB 34 for this area. We had just one adjustment which occurred during the audit to pickup governmental fund capital projects in progress as capital asset additions at the government-wide (consolidation) level. We reviewed this with staff and they are now aware that all costs incurred to get an asset ready for its intended use must be capitalized in the year incurred. The City will need to change its closing procedures next year to pick up these costs as capital assets prior to commencement of the audit.

- Managements Discussion and Analysis – This expanded and thorough analysis for the City overall financial positions and activities was prepared by staff along with our assistance. We aided the City in the overall content and structure of the document this year as well as assisting in the preparation of the MD&A. We also drafted the Public Improvement Corporation MD&A this year. We assisted in the preparation of the Transmittal Letter this year as well.

With fiscal 2002-2003, new independence rules take effect which do not permit auditors to perform these tasks. Staff will need to take over these functions completely next year.

- Internal Balances – GASB 34 restricts the reporting of interfund loans and advances when there are no specified repayment terms. As is the case with many newly formed Redevelopment Agencies, the Palo Alto Redevelopment Agency borrowed \$255 thousand from the City to fund start-up costs. However, since there are no specified repayment terms, the borrowings could not be reflected as interfund balances owed by the Agency. As part of our audit we recommended and staff concurred that the advance to the Redevelopment Agency had to be accounted for as a transfer.

As part of the next years close, Staff needs to review interfund balances for conformity with GASB 34 and those which do not have specified repayment terms will need to be reclassified.

There were other areas such as Program Revenue Allocations, internal service fund elimination bases, governmental activity debt transactions were prepared by staff without difficulty. The consolidation of the government-wide statements for the City and Public Improvement Corporation were completed as part of the financial statements and footnotes and were completed with minimal difficulty due to the prompt cooperation and technical knowledge of staff.

Staff Response: Recommendations will be implemented in FY 02-03.

CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL STRUCTURE

Redevelopment Agency Start-up Issues

We have discussed with staff the need for a separate audit of the newly formed Redevelopment Agency. So far we have not been engaged to perform any Redevelopment Agency audit work. Redevelopment Agency audits are required to be submitted to the State to report on the financial statements of the Agency as well as to report on compliance with certain provisions of the Health and Safety Code. The Agency has not yet approved the project area nor has it begun to receive tax increment. These two steps are by far the most significant of the areas that are affected by compliance requirements and audit tests.

We have informed staff that once the project area has been established a Statement of Indebtedness, as well as other filings, will need to be submitted to the County before tax increment will be allocated the Agency to fund operations. The Statement is due October 1st of each year.

Also we were informed by one of our other Redevelopment clients which received tax increment in 2001-2002 that their County had made a calculation error in assessing and remitting tax increment to that Agency. As a result, that Agency must return in excess of 75 percent of its tax increment to the County. The City should verify the calculation of tax increment when it comes in from the County to ensure it is accurate.

Lastly, Health and Safety code requirements applicable to Agencies requires the pass-through of a portion of tax increment to affected jurisdictions. In some cases these pass-throughs are calculated and remitted by Counties on behalf of Redevelopment Agencies. Compliance rules require that these pass-throughs be reflected as expenditures. Staff will need to contact the County to obtain this data to ensure it is accurately reflected on the Agencies records.

Staff Response: Finance staff has met with the City's Economic Resources Manager, Susan Arpan and confirmed the following in regards to RDA. The Agency has not yet approved the project area nor has it begun to receive tax increments. Susan estimates that approval of the project area would be in February, 2003, file with the County in July/Aug 2003 and receive tax increments in the following year.

Medical Retiree Liability

Questions from staff have come up this year about the unfunded liability for retiree health care benefits and whether that liability can be recorded in the City's financial statements. Current accounting and financial reporting standards do not require recording the liability and by far the vast majority of Cities simply disclose the amount and the method of paying benefits. An unfunded liability determined by an actuary is an educated guess about how much will be needed to satisfy a benefit. Actuaries may use a variety of methods and assumptions to determine the amount of an unfunded liability. Different actuaries will come up with significantly different amounts reported as unfunded liabilities.

The Governmental Accounting Standard Board establishes generally accepted accounting principals for governments and is working on a project to change the way governments account for and report these benefits. We have discussed this with staff, and recommend that the City wait for the preliminary rules to be issued before recording a liability. We will keep you informed as the issue develops.

Staff Response: The liability will not be recorded in the City's financial statements pending direction from GASB.

CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL STRUCTURE

Fraud Detection & Prevention

Staff informed us that during the year, two of the City's bank accounts were reduced for fraudulent checks approximating \$50,000. To its credit, Staff detected the fraud and informed the bank which has reimbursed the City. To reduce the risk of loss in the future the City implemented the Positive Pay System under which the City will electronically transmit check numbers and amounts to the bank. The Bank will then use this data to ensure only authorized checks are cleared which will reduce the risk of loss from fraud.

Staff Response: New check stock with numerous security features was ordered and is in use.

GANN Limit

During our review of the City's Appropriation Limit we recomputed a revised Limit to be \$83,243,258 by multiplying the Prior Year Appropriations Limit by annual adjustment factors. The City's 2001-2002 Appropriations Limit of \$81,800,246 was based on the County's Population Growth Factor which was lower than the City's Population Growth Factor. The City in calculating the Appropriations Limit has the option of selecting either the City's or County's Population Growth Factor. We recommend that in the future the City maximize its Appropriation Limit by selecting the higher of the City or County Population Growth Factor.

Staff Response: The recommendation has been implemented for FY02-03

Disbursements

During our testing of cash disbursements we noted the following from our sample of forty:

- One check was supported by an invoice, which did not total to the amount paid by \$7.50. The vendor did not properly total the invoice and the City did not recalculate it. We recommend that invoices be totaled to assure the accuracy of amounts paid.

Staff Response: The bill was calculated as 42.75 hrs x \$150.00 per hour, instead of 42.8 hrs. x \$150.00 per hour, which caused a \$7.50 variance. The invoice footed correctly, but it was the rounding of the decimal to the 10th. The department should have caught this.

- Another check was used to pay three invoices but only one invoice was entered into the system. This was due to the final invoice including the carry forward balances of the other two invoices. We noted that these two invoices had previously been paid and the vendor returned the overpayment. We recommend that each individual invoice be entered in to the system to reduce the risk of duplicate payments.

Staff Response: Yes, each individual invoice should be entered into the system. The Department and the A/P staff have been informed of the way this particular vendor submits their invoice. They need to make sure that we only pay the current invoice amount, not the aged receivables.

CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL STRUCTURE

- A third check had departments using the vendor number instead of the invoice number to enter it into the system. We understand that the system generated an error and a handwritten correction was made. We recommend the invoice number be used to reduce the risk duplicate payments.

Staff Response: Palo Alto Daily News invoices many departments within the City. It is much more secure for the departments to issue purchase orders for their ads to eliminate duplicate payments. The departments and A/P staff have been informed to enter ad numbers as invoice numbers.

- Out of our sample of forty disbursements, faxed or copied invoices supported five.

Staff Response: Seeing that invoices are sent to various facilities within the City, it is easy for invoices to become lost. The A/P staff are now using a stamp for all faxed and copied invoices to indicate that they have verified that it is not already paid.

**CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL STRUCTURE**

STATUS OF PRIOR YEAR RECOMMENDATIONS

Recommendation #01-1 - Bond Defeasance Monitoring

Status: Implemented.

Recommendation #01-2 - Wire Transfer Authorization

Status: Implemented.

Recommendation #01-3 - Bank Reconciliation Review

Status: Implemented.

Payroll

Status: Implemented.

Recommendation #01-4 - Disbursements

Status: Implemented.

Recommendation #01-5 - Cash Receipts Approvals

Status: Implemented.

Recommendation #01-6 - Claims

Status: Implemented.

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**INDEPENDENT AUDITOR'S REPORT ON
COMPLIANCE WITH THE PROPOSITION 111
2001-2002 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, 2002. 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 2001-2002 Appropriations Limit of \$81,800,246 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 2001-2002 Appropriations Limit to be \$83,243,258 by multiplying the 2000-2001 Prior Year Appropriations Limit by the annual adjustment factors. The City's 2001-2002 Appropriations Limit of \$81,800,246 was based on the County's Population Factor which was lower than the City's Population Factor.
- 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.

Based on the application of the procedures referred to above, nothing came to our attention except as noted above which caused us to believe that the City's Appropriations Limitation Worksheet was not computed in accordance with Article XIII B of the California Constitution, as interpreted in the California League of Cities Article XIII B Appropriations Limit Uniform Guidelines. 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

April 22, 2002

**CITY OF PALO ALTO
PUBLIC IMPROVEMENT CORPORATION
COMPONENT UNIT FINANCIAL STATEMENTS
FOR THE YEAR ENDED
JUNE 30, 2002**

<p>CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION COMPONENT UNIT FINANCIAL STATEMENTS FOR THE YEAR ENDED JUNE 30, 2002</p>

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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 Palo Alto Public Improvement Corporation, a component unit of the City of Palo Alto, as of and for the year ended June 30, 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 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 Palo Alto Public Improvement Corporation as of June 30, 2002, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles in the United States of America.

The basic financial statements referred to above follow the requirements of 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*, as discussed in Note 1 to the Basic Financial Statements.

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 31, 2002

MANAGEMENT'S DISCUSSION AND ANALYSIS

This year the Palo Alto Public Improvement Corporation, a component unit of the City of Palo, 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.

GASB 34 requires the Corporation to make substantial changes to its financial statement format; one of these requirements is that the Corporation provide this discussion and analysis of its financial activities for the fiscal year. Other changes will be described in the financial statements themselves. Please read this document in conjunction with the accompanying Basic Financial Statements (fiscal 2001 amounts referred to below have been recast in the GASB 34 format for comparison purposes, when practical).

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

The Corporation's revenues are primarily determined by the debt service requirements of its Certificates of Participation (COPs) issues, and are not directly affected by the local economy.

FISCAL 2002 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 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 \$443 thousand in fiscal 2002. The interest on leases on the assets securing these COPS issues was \$342 thousand; these revenues together with the accounting gain above and \$88 thousand in interest income resulted in an income of \$123 thousand in fiscal 2002.

The Corporation ended fiscal 2002 with total assets of \$13.9 million, including \$5.0 million in cash and \$8.7 million in present value of leases receivable from the City of Palo Alto. It had liabilities of \$13.9 million, including \$13.7 million in long-term debt.

At the Fund level, the Corporation reported a \$2.9 million excess of revenues over expenditures, which was principally the excess of the net proceeds from new COPs issues over the amounts paid to refund the earlier issue.

The Corporation has two funds, the Debt Service Fund, which reported a \$1.4 million fund balance at June 30, 2002, and the Capital Projects Fund, which reported a \$3.5 million fund balance at that date.

OVERVIEW OF THE CORPORATION'S BASIC FINANCIAL STATEMENTS

The Basic Financial statements are in two parts:

- 1) Management's Discussion and Analysis (this part),
- 2) The Basic Financial Statements, which include the Corporation-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 Statement of Net Assets and the Statement of Activities. The Statement of Net Assets provides information about the financial position of the Corporation as a whole, including all its long-term liabilities on the full accrual basis, similar to that used by corporations. The Statement of Activities provides information about all the Corporation's revenues and 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. There were two new COPs issues in fiscal 2002, one of which refunded an earlier issue.

ECONOMIC OUTLOOK AND MAJOR INITIATIVES

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

CONTACTING THE CORPORATION'S FINANCIAL MANAGEMENT

These Basic Financial Statements are intended to provide citizens, taxpayers, investors, and creditors with a general overview of the Corporation's finances. Questions about these Statements should be directed to the Finance Department of the City of Palo Alto, 250 Hamilton Avenue, Palo Alto, CA 94303.

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 are entirely new statements required by Government Accounting Standards Board Statement 34. Their 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, 2002

ASSETS

Cash and investments held by trustee (Note 3)	\$4,959,112
Interest receivable	15,505
Construction in progress	166,054
Investment in leases to City of Palo Alto (Note 2E)	<u>8,735,888</u>
Total Assets	<u>13,876,559</u>

LIABILITIES

Interest payable	231,023
Long-term debt (Note 4):	
Due in one year	790,000
Due in more than one year	<u>12,905,000</u>
Total Liabilities	<u>13,926,023</u>

NET ASSETS

Unrestricted	<u>(49,464)</u>
Total Net Assets	<u><u>(\$49,464)</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, 2002

EXPENSES	
Interest and fiscal agent charges	\$443,923
Total Program Expenses	443,923
REVENUES	
Interest on leases from City of Palo Alto	341,912
Net Program Expenses	(102,011)
GENERAL REVENUES	
Interest from cash and investments	87,902
Change in Net Assets, before extraordinary item	(14,109)
Extraordinary Item - Gains on refunding of debt	136,612
Change in Net Assets	122,503
Net assets at the beginning of year	(171,967)
Net assets at the end of year	(\$49,464)

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

GASB 34 revises the format of the Fund Financial Statements so that only individual major funds are presented, while non-major funds are combined in a single column. 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 2002.

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.

A COMPONENT UNIT OF THE CITY OF PALO ALTO
BALANCE SHEET
JUNE 30, 2002

	Debt Service	Capital Projects	Totals
ASSETS			
Cash and investments held by trustee (Note 3)	\$1,435,435	\$3,523,677	\$4,959,112
Interest receivable	11,471	4,034	15,505
Investment in leases to City of Palo Alto (Note 2E)	8,735,888		8,735,888
Total Assets	\$10,182,794	\$3,527,711	\$13,710,505
LIABILITIES			
Deferred revenue	\$8,735,888		\$8,735,888
Total Liabilities	8,735,888		8,735,888
FUND BALANCES			
Reserved for:			
Debt service	1,446,906		1,446,906
Capital projects		\$3,527,711	3,527,711
Total Fund Balances	1,446,906	3,527,711	4,974,617
Total Liabilities and Fund Balances	\$10,182,794	\$3,527,711	
Accrual adjustment to remove deferred revenue from the balance sheet			
Deferred revenue			8,735,888
Construction in Progress used in governmental activities is not a financial resource and therefore not reported in funds			166,054
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			(231,023)
Due within one year			(790,000)
Due in more than one year			(12,905,000)
NET ASSETS OF GOVERNMENTAL ACTIVITIES			(\$49,464)

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, 2002

	<u>Debt Service</u>	<u>Capital Projects</u>	<u>Totals</u>
REVENUES			
Lease receipts from City of Palo Alto:			
Principal	\$390,000		\$390,000
Interest	341,912		341,912
Interest from cash and investments	54,955	\$32,947	87,902
	<u>786,867</u>	<u>32,947</u>	<u>819,814</u>
EXPENDITURES			
Debt service:			
Principal repayment	390,000		390,000
Interest and fiscal agent charges	639,053		639,053
Capital projects		121,909	121,909
	<u>1,029,053</u>	<u>121,909</u>	<u>1,150,962</u>
EXCESS OF REVENUES OVER (UNDER) EXPENDITURES	<u>(242,186)</u>	<u>(88,962)</u>	<u>(331,148)</u>
OTHER FINANCING SOURCES (USES)			
Proceeds from long term debt (Note 4)	3,953,701	3,101,299	7,055,000
Payment to refunded bond escrow agent (Note 4)	(3,819,965)		(3,819,965)
	<u>133,736</u>	<u>3,101,299</u>	<u>3,235,035</u>
EXCESS OF REVENUES AND OTHER FINANCING SOURCES OVER (UNDER) EXPENDITURES AND OTHER USES	<u>(108,450)</u>	<u>3,012,337</u>	<u>2,903,887</u>
Fund balances at beginning of year	<u>1,555,356</u>	<u>515,374</u>	<u>2,070,730</u>
Fund balances at end of year	<u><u>\$1,446,906</u></u>	<u><u>\$3,527,711</u></u>	<u><u>\$4,974,617</u></u>

See accompanying notes to financial statements.

PALO ALTO PUBLIC IMPROVEMENT CORPORATION
STATEMENT OF REVENUES, EXPENDITURES AND
CHANGES IN FUND BALANCES
GOVERNMENTAL FUNDS TO THE
STATEMENT OF ACTIVITIES - FOR THE YEAR ENDED JUNE 30, 2002

Net change in fund balances-total governmental funds \$2,903,887

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

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.

Proceeds of issuance of long term debt	(7,055,000)
Net assets increased for refunded debt recorded against loss on refunding	3,670,000
Fund balance is increased by the amount of debt repayment	390,000

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	166,054
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Some amounts reported in the Statement of Revenues, Expenditures and Changes in Fund Balances
reflect the collection of an asset which are not includable as revenues on the Statement of Activities

Change in Investment in leases	104,353
Change in Interest payable	<u>(56,791)</u>

Change in net assets of governmental activities	<u><u>\$122,503</u></u>
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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

A. 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, 2002.

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 2001-2002, interest costs amounting \$44,145 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.

As a result of adopting GASB 34 the Corporation changed its method of measuring Investment in Leases from recording such receivables at the par value of the lease to recording them at par value net of cash and investments held by the Corporations and trustee. The reason for this change in accounting is that GASB 34 required full accrual accounting to be used and that assets should be reflected at their net realizable value. The underlying lease agreements provide that any remaining cash on hand after repayment of each lease is to be refunded to the City. This in effect means the Corporations would only receive the net lease obligation after deducting cash on hand from the City. The amount reported in prior year financial statements as Investment in Leases have been reduced by \$2,068,465 representing cash on hand to reflect this change in accounting method as of July 1, 2001.

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, 2002. 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, 2002 the Corporation's investments were recorded at market value and comprised the following:

Category 1 Investments:

U.S. Agency Obligations	\$719,097
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Pooled Investments (non Categorized):

California Arbitrage Management Program	2,435
Mutual funds	<u>4,237,580</u>

Total cash and investments held by trustee	<u><u>\$4,959,112</u></u>
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**CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO**

*** Notes to Financial Statements**

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.

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, 2001	Additions	Retirements	Balance June 30, 2002	Current Portion
Governmental Activity Debt:					
Certificates of Participation					
1992 Civic Center, 3.60-6.70%, due 03/01/2012	\$3,670,000		\$3,670,000		
1998 Golf Course 4.00-5.00%, due 09/01/2018	7,030,000		390,000	\$6,640,000	\$405,000
2002A Civic Center Refinancing 2.00-4.00%, due 03/01/2012		\$3,500,000		3,500,000	300,000
2002B Downtown Parking Improvements 4.55-6.00%, due 03/01/2022		3,555,000		3,555,000	85,000
	<u>\$10,700,000</u>	<u>\$7,055,000</u>	<u>\$4,060,000</u>	<u>\$13,695,000</u>	<u>\$790,000</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. The refunding resulted in an overall savings of future debt service payments of \$372 thousand and an economic gain of \$191 thousand. 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.

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 (in thousands):

For the Year Ending June 30	Governmental Activities	
	Principal	Interest
2003	\$405	\$297
2004	270	284
2005	285	272
2006	295	260
2007	310	248
2008-2012	1,770	1,024
2013-2017	2,240	556
2018-2022	2,130	108
Total	\$7,705	\$3,049

The Bond documents require a Trustee to hold a portion of proceeds in a reserve fund for debt service purposes only. At June 30, 2002, the Trustee held \$1.395 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 adds 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, 2002**

**CITY OF PALO ALTO REGIONAL WATER QUALITY CONTROL PLANT
FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2002**

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ACCOUNTANCY CORPORATION
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INDEPENDENT AUDITOR'S REPORT

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

We have audited the accompanying statements of Net Expenditures and Net Changes in Commitments and Quarterly Billings of the City of Palo Alto Regional Water Quality Control Plant, a component unit of the City of Palo Alto, for the year ended June 30, 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 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, 2002 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 31, 2002

CITY OF PALO ALTO
REGIONAL WATER QUALITY CONTROL PLANT
STATEMENT OF NET EXPENDITURES AND NET CHANGES IN COMMITMENTS
FOR THE YEAR ENDED JUNE 30, 2002

	Totals	City of Mountain View	City of Los Altos	City of Palo Alto
DIRECT EXPENDITURES:				
Source control program	\$1,028,735	\$376,826	\$131,575	\$520,334
Public Outreach	106,868	39,146	13,668	54,054
Permitting and enforcement	695,772	244,779	16,387	434,606
Operations and maintenance	7,466,300	2,734,906	954,940	3,776,454
System improvement CIP (Note 2)	1,117,878	409,479	142,977	565,422
Total Direct Expenditures	10,415,553	3,805,136	1,259,547	5,350,870
INDIRECT ADMINISTRATIVE EXPENDITURES:				
Source control program	208,846	76,500	26,712	105,634
Permitting and enforcement	334,112	115,190	7,711	211,211
Operations and maintenance	1,363,170	499,329	174,349	689,492
Total Indirect Expenditures	1,906,128	691,019	208,772	1,006,337
DEBT SERVICE EXPENDITURES:				
Refunding 1990 Series A Bonds	310,635	158,424	24,230	127,981
1999 Wastewater Treatment New Project	542,798	205,666	51,403	285,729
Total Debt Service Expenditures	853,433	364,090	75,633	413,710
TOTAL EXPENDITURES	13,175,114	4,860,245	1,543,952	6,770,917
DEDUCT JOINT SYSTEMS REVENUES (Note 5)	(50,783)	(18,603)	(6,495)	(25,685)
NET EXPENDITURES	13,124,331	4,841,642	1,537,457	6,745,232
ADD NET CHANGES IN COMMITMENTS	689,150	252,436	88,142	348,572
NET EXPENDITURES AND NET CHANGES IN COMMITMENTS DUE FROM MEMBERS	\$13,813,481	\$5,094,078	\$1,625,599	\$7,093,804

See notes to financial statements

CITY OF PALO ALTO
 REGIONAL WATER QUALITY CONTROL PLANT
 STATEMENT OF QUARTERLY BILLINGS
 FOR THE YEAR ENDED JUNE 30, 2002

	City of Mountain View	City of Los Altos
BILLINGS BY QUARTER BEGINNING:		
July 1, 2001	\$1,362,786	\$391,683
October 1, 2001	1,366,920	387,287
January 1, 2002	1,308,003	377,561
April 1, 2002	1,557,396	429,096
Total quarterly billings	5,595,105	1,585,627
Net expenditures and net changes in commitments	5,094,078	1,625,599
Excess of net expenditures and net changes in commitments over total billings	\$501,027	(\$39,972)

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 general purpose 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 general purpose financial statements of the City.

Plant expenditures, commitments and joint system revenues, debt service and industrial waste compliance expenditures are shared by the Members based on agreed upon allocation percentages. The expenditures and commitments, including indirect administrative expenditures (see Note 3), are allocated to each of the Members based primarily on their respective percentages of the annual sewage flow and treatment needed for suspended solids, chemical oxygen demand and ammonia. Commitments represent operating encumbrances with suppliers for long-term projects which have not yet been completed. Net changes in commitments represent commitments of \$3,125,259 at June 30, 2002 less commitments of \$2,436,109 at June 30, 2001. 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, 2002 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	36.63%	12.79%	50.58%
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	34.95%	2.34%	62.71%

The City is allocated 50.58% 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 2001-2002 allocations are as follows:

East Palo Alto Sanitary District	7.47%
Stanford University	5.20%
Town of Los Altos Hills	0.91%
Remaining City percentage	<u>37.00%</u>
Total	<u><u>50.58%</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 \$1,117,878 for 2001-2002.

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, 2002, 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 \$10,610,007.

**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	\$2,654,027	\$913,751	\$3,567,778
City of Mountain View	2,635,250	1,864,054	4,499,304
City of Los Altos	658,639	285,091	943,730
Town of Los Altos Hills	531,362	434,946	966,308
East Palo Alto Sanitary District	365,833	149,855	515,688
Stanford University	109,889	7,310	117,199
Total	<u>\$6,955,000</u>	<u>\$3,655,007</u>	<u>\$10,610,007</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, 2002, totaled \$50,783. This consisted of \$15,000 for salt water marsh services, \$42,992 from the City's Water Fund for lab services, \$36,895 for septic tank hauling services and \$1,066 for other revenues. During the fiscal year joint system revenue in the amount of \$45,170 was written off due to a company discontinuing operations.

NOTE 6 - RELATED PARTY TRANSACTIONS

During fiscal 2002, the Plant paid the City \$1,628,421 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 \$24,980 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 COOPERATIVE FRANCHISE

**STATEMENTS OF FRANCHISE
REVENUES AND EXPENDITURES**

**FOR THE YEARS ENDED
DECEMBER 31, 2001 AND 2000**

**CABLE COOPERATIVE FRANCHISE
STATEMENT OF FRANCHISE
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FOR THE YEARS ENDED DECEMBER 31, 2001 AND 2000**

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INDEPENDENT AUDITOR'S REPORT

The Members of the Cable
Cooperative Franchise

We have audited the accompanying Statements of Franchise Revenues and Expenditures of the Cable Cooperative Franchise (Franchise) for the years ended December 31, 2001 and 2000 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, 2001 and 2000 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

April 22, 2002

CABLE COOPERATIVE FRANCHISE
 STATEMENTS OF FRANCHISE REVENUES AND EXPENDITURES
 YEARS ENDED DECEMBER 31, 2001 AND 2000

	2001	2000
REVENUES:		
Franchise fees	\$819,389	\$843,220
Total Receipts	819,389	843,220
EXPENDITURES:		
Franchise administration	60,751	23,502
Consulting fees	16,539	
Total Expenditures	77,290	23,502
Net Receipts	\$742,099	\$819,718

DISTRIBUTED NET RECEIPTS:

	2001		2000	
	Amount	Percent	Amount	Percent
Allocation of Net Receipts:				
City of Palo Alto	\$375,642	51%	\$421,984	51%
City of Menlo Park	195,788	27%	217,135	26%
Town of Atherton	53,365	7%	57,706	7%
City of East Palo Alto	76,598	10%	81,842	11%
County of San Mateo	16,134	2%	21,168	3%
County of Santa Clara	24,572	3%	19,883	2%
Total	\$742,099	100%	\$819,718	100%

See accompanying notes to financial statements

**CABLE COOPERATIVE FRANCHISE
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 July 24, 2001 the City, acting on behalf of the Members, signed a Franchise Agreement with TCI Cablevision of California, Inc., a 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.

TCI has also signed an asset purchase agreement with Cable Communications Cooperative of Palo Alto, Inc. (CCCOPA), the former cable television system operator/owner, to acquire 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 Cable Cooperative Franchise (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 general purpose 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, TCI 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.

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

NOTE 2 - PRIOR FRANCHISE SETTLEMENTS

The 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. A portion of the consultant and attorney costs has been deducted from franchise revenues. 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 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 Cable Cooperative Agency Fund of the City and are earning interest. As of December 31, 2001, the total amount on deposit amounted to \$712,000.

CITY OF PALO ALTO
BICYCLE/PEDESTRIAN PROJECTS
FINANCIAL STATEMENTS
FOR THE YEARS ENDED
JUNE 30, 2002 AND 2001

CITY OF PALO ALTO
Bicycle/Pedestrian Projects
Financial Statements
For the Years Ended June 30, 2002 and 2001

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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, 2002 and 2001, 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, 2002 and 2001 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 30, 2002

CITY OF PALO ALTO
BICYCLE/PEDESTRIAN PROJECTS
BALANCE SHEETS
JUNE 30, 2002 AND 2001

	<u>2002</u>	<u>2001</u>
ASSETS		
Cash	\$3,029	
Accounts receivable	<u>117,090</u>	<u>\$51,706</u>
Total Assets	<u>\$120,119</u>	<u>\$51,706</u>
LIABILITIES		
Advance from MTC	\$3,029	\$2,936
Due to the City	<u>117,090</u>	<u>48,770</u>
Total Liabilities	<u>\$120,119</u>	<u>\$51,706</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, 2002 AND 2001

	2002	2001
REVENUE		
TDA Article 3.0 (Note 2)	\$117,090	\$61,843
TOTAL	\$117,090	\$61,843
EXPENDITURES		
San Mateo Drive Bike Bridge	\$2,600	\$13,433
Design and Engineering for Arastradero Bike Lanes Project	80,324	28,923
Embarcadero Bike Bridge	34,166	19,487
TOTAL	\$117,090	\$61,843

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, 2002
00-3154-092	Arastradero Bridge and Extension	\$80,324	\$80,324
01-3270-080	California Avenue and US 101 Bike Project	15,993	
01-3270-081	Pedestrian Walkway Warning System	20,000	
02336623	Sidewalk improvement	50,000	
02336624	Bicycle education safety program	5,000	
02336625	Upgrade bicycle facilities in high demand areas	5,209	
02336626	Embarcadero Bridge and Extension	95,510	34,166
02336627	San Mateo Drive Bike Bridge	6,567	2,600
			\$117,090