



CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

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

December 16, 2008

Maze & Associates' Audit of the City of Palo Alto's Financial Statements as of June 30, 2008 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 that audit in writing to the City Council. Maze & Associates, an accountancy corporation based in Pleasant Hill, California, conducted the audit of the City's financial statements as of June 30, 2008. The Independent Auditor's Report (the "opinion letter") and Single Audit Report (the audit of federal funds received by the City which includes the report on internal control over financial reporting and the OMB Circular A-133 compliance requirements supplement) are included in the Comprehensive Annual Financial Report for the fiscal year ended June 30, 2008.

Maze & Associates also completed the following reports for the City of Palo Alto, shown as attachments:

- Attachment A: Memorandum on Internal Control and Required Communication for the year ended June 30, 2008 (the "management letter");
- Attachment B: Independent Auditor's Report on Compliance with the Proposition 111 2007-2008 Appropriation Limit Increment (the "Gann limit letter");
- Attachment C: Public Improvement Corporation Basic Component Unit Financial Statements for the year ended June 30, 2008;
- Attachment D: Regional Water Quality Control Plant Financial Statements for the year ended June 30, 2008;
- Attachment E: Cable TV Franchise Statements of Revenues and Expenditures for the years ended December 31, 2007 and 2006; and
- Attachment F: Redevelopment Agency of the City of Palo Alto Basic Component Unit Financial Statements for the year ended June 30, 2008.

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,

A handwritten signature in cursive script that reads "Lynda Flores Brouchoud".

Lynda Flores Brouchoud
City Auditor

Attachments

**CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS**

**FOR THE YEAR ENDED
JUNE 30, 2008**

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**CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS**

For the Year Ended June 30, 2008

Table of Contents

	<u>Page</u>
<i>Memorandum on Internal Control</i>	1
Schedule of Other Matters.....	4
Status of Prior Year Schedule of Other Matters	9
<i>Required Communications</i>	11
Financial Statement Audit Assurance.....	11
Other Information Included with the Audited Financial Statements	11
Accounting Policies	12
Unusual Transactions, Controversial or Emerging Areas	12
Estimates.....	13
Disagreements with Management.....	14
Retention Issues.....	14
Difficulties	14
Audit Adjustments	14
Uncorrected Misstatements	14

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MEMORANDUM ON INTERNAL CONTROL STRUCTURE

October 24, 2008

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

In planning and performing our audit of the financial statements of the City of Palo Alto as of and for the year ended June 30, 2008, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We noted no matters that we consider to be material weaknesses, however, we identified certain deficiencies in internal control that we consider to be significant deficiencies that are included on the Schedule of Significant Deficiencies

Included in the Schedule of Other Matters are recommendations not meeting the above definitions that we believe to be of potential benefit to the City.

The City's written responses included in this report have not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

This communication is intended solely for the information and use of management, City Council, others within the organization, and agencies and pass-through entities requiring compliance with generally accepted government auditing standards, and is not intended to be and should not be used by anyone other than these specified parties.

Maze & Associates

A Professional Corporation

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CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL STRUCTURE
SCHEDULE OF SIGNIFICANT DEFICIENCIES

2008-01 – Journal Entry Review

We selected a control sample of twenty journal entries to test the effectiveness of journal entry processing, procedures and adequacy of documentation. We noted that Accountants and Senior Accountants are authorized to prepare and approve journal entries and that journal entries are required to be reviewed by Senior Accountants. However, out of our sample of twenty entries, eleven were prepared and posted by the same Senior Accountant without a second employee review. We noted that these eleven were properly supported, appropriate and accurately recorded. We also noted that this employee's primary functions include review and analysis of transactions and balances, but do not include access to cash, collections or other assets. The results of this initial control sample were supplemented by our year end tests of a multitude of other journal entries which were also properly supported, appropriate and accurately recorded. Through our tests and audit we satisfied ourselves that the risk of material error or material unauthorized entry was mitigated due to the involvement of the City's other administrative staff. We recommend that the City designate a second employee review of entries to reduce the risk of unauthorized entries or errors.

Management Response: The Accounting Manager performs a top down analysis of all fund financial statements on a periodic basis during the fiscal year. In addition, the Senior Accountants discuss and review complex journal entries with the Accounting Manager, seeking guidance as needed. However, the Accounting staff strives to follow recommended best practices. In addition to the analysis of financial statements, the accounting manager will review and post journal entries written by Senior Accountants that exceed a \$50,000 threshold (per line entry). In the absence of the Accounting Manager, the assigned acting Accounting Manager will review and post journal entries. Implementation will commence as of December 2008 closing of the books.

CURRENT STATUS OF PRIOR YEAR SIGNIFICANT DEFICIENCIES

2007-01: Receivable Valuation Allowance Policy

Current Status: Administrative Services and program staff meet to discuss the collectability of loans before the interim audit with an update at year end as part of the regular review policy. The FY 2006-07 auditors' recommendation for the allowance has been fully recognized in FY 2007-08 by adjusting the allowance for collectability by approximately \$5.5 million.

CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL STRUCTURE

SCHEDULE OF OTHER MATTERS

2008-02 – Information Technology Best Practices

We conducted an Information Systems Review with our audit which encompassed the financial information system and the network environment that houses it. We significantly expanded our work from previous years beyond looking solely at financial information systems as a result of greater risks of unauthorized access caused by overall industry growth of web-based commerce and internet based financial systems. Internal controls that are present in the overall network environment have become more important and relevant to understanding the internal controls over financial systems. We believe Information System controls must be continuously improved and enhanced to stay ahead of the ever increasing sophistication of hackers and criminals.

Currently, there are no Information Technology standards which local governments are required to conform to. Indeed there are a wide variety of informal guidelines and suggested controls from many different organizations which local governments may use to implement appropriate controls to ensure adequate security over information technology. Our Information Technology staff have reviewed these informal guidelines and concluded that the certification and accreditation framework developed by the National Institute of Standards and Technology (NIST) for the Federal Information Security Management Act (FISMA) are the most appropriate for local government. NIST and FISMA represent the minimum security requirements for federal government agencies information systems. We understand the U.S. Department of Justice recommends these for local governments. Our procedures included performing an external network scan based on NIST criteria and in determining that internal control provides for:

- Internet access defenses including hacker prevention, detection and deterrent systems
- Security of data from physical or network access
- Adequately protecting data from unauthorized internal access
- Reasonable measures to ensure continuation of service

While the results of our work did not indicate weaknesses or serious exploitable vulnerabilities, we did note a few areas which could be improved to conform to NIST guidelines. A summary of these recommendations which we believe are “best practices” are as follows:

- *Payment Card Industry Compliance* - Any organization that processes credit cards is required to comply with the Payment Card Industry Data Security Standard (PCI-DSS), even if the processing is outsourced. The standard was developed to minimize the risk of loss due to security breaches in processing credit card transactions. Merchants which conform to the Standard pay lower transaction fees than those that do not comply and they minimize their liabilities which may result from security breaches. The Standard requires varying levels of controls depending on transaction levels. In general, merchants must:
 1. Fill out a self-assessment questionnaire (SAQ).
 2. Submit the SAQ to acquiring banks.
 3. Perform quarterly external network scans and submit the results to acquiring banks.
 4. Have a full independent PCI audit performed by a Qualified Security Assessor (QSA) and submit it to acquiring banks. (Required for level 1 merchants only).

CITY OF PALO ALTO

MEMORANDUM ON INTERNAL CONTROL STRUCTURE

SCHEDULE OF OTHER MATTERS

We believe the City qualifies as a Level 3 or 4 merchant due to activity levels of less than 1 million transactions and currently it need only complete and maintain the SAQ in-house. However, we understand SAQ submissions will become mandatory for Level 3 and 4 merchants within the near future. Staff have not completed the SAQ, but should do so and prepare for the submission requirement.

- *General Information Systems Controls* - We compared the City's information systems controls with the various NIST standards and believe improvements should be considered for implementation such as formalizing business continuity plans including alternate processing site locations, contingency planning and training. We provided a detailed report to the City Auditor and the City's Administrative Services staff which describes the relevant standards and the control status for their consideration.

As noted above, the City is not required to conform to NIST standards and could use another set of guidelines to ensure the adequacy of controls. However, we recommend the City select an appropriate industry standard such as NIST to plan, organize and monitor information security proactively.

Management Response:

Staff believes that the request above is consistent with the information/procedures addressed in the response by the Utilities Department to the UAC regarding the Fair and Accurate Credit Transaction Act of 2003 (FACT Act) and attached draft Disaster Recovery Plan. Staff will comply with the recommendation to fill out and keep on file a Self-Assessment Questionnaire (SAQ).

CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL STRUCTURE
SCHEDULE OF OTHER MATTERS

2008-03 – Elimination of Old Utility Receivables

During fiscal 2007-08, staff determined that approximately \$850,000 in utility accounts receivable balances which had accumulated over many years had not been written off. While these accounts had been identified as accounts with doubtful collectability and staff had recorded a reserve for doubtful accounts to offset these balances, the accounts had not been forwarded to collections, pursued for collection or written off in a timely manner. Staff have since taken action to resolve these old accounts and have amended procedures to ensure such accounts do not languish unattended in the future.

Such doubtful accounts should continually be analyzed for collection potential, resolved by forwarding to collections or written off in accordance with policy.

Management Response:

In alignment with the new Bad Debt, Collection, and Write-off business processes adopted by the Utilities Credit & Collection Department in February of 2008, Enterprise Accounting now serves as the Back office Audit to the following transactions:

Review and monitor Bad Debt accounts through Aging Reports on a monthly basis;
Review Utility Customer Accounts assigned to the external collection agency, Collection Bureau of America (CBA), through IT system generated and Utilities Credit & Collection reports on a monthly basis; and, Review Utility Customer Accounts, beyond the statute of limitation, for Write-off through IT system generated and Utilities Credit & Collection write-off reports on a quarterly basis.

The review and monitoring of these transactions are in direct support of adherence to the attached "Write-off Policy for Utilities Bad Debt". Quarterly audit reports to management are currently being developed.

Enterprise Accounting continues to record and reserve for doubtful accounts using the accumulated methodology. The financial data is represented accurately; however, staff has identified the need for increased transparency. By fiscal year end 2009, in connection to implementation of the Utilities CCS module within SAP, the Doubtful Account Audit Schedule will be revised and updated to increase transparency of transactions.

2008-04- Upcoming GASB Statement No. 51, Accounting and Financial Reporting for Intangible Assets (Effective for fiscal 09/10) - Retroactive Application Required

Governments have different types of intangible assets, such as easements, water rights, patents, trademarks, and computer software. Easements are referred to in the GASB 34 description of capital assets, which has raised questions about whether and when intangible assets should be considered capital assets for financial reporting purposes.

The absence of specific authoritative guidance has resulted in inconsistencies in the recognition, initial measurement, and amortization of intangible assets among governments. The objective of this Statement is to establish accounting and financial reporting requirements for intangible assets to reduce inconsistencies and enhance comparability.

CITY OF PALO ALTO

MEMORANDUM ON INTERNAL CONTROL STRUCTURE

SCHEDULE OF OTHER MATTERS

A summary of the statement:

- Intangible assets should be classified, accounted for and reported as capital assets, unless excluded from the scope. Guidance in this statement is in addition to existing capital asset guidance.
- GASB 51 specifically addresses the nature of intangible assets.
 - *Lack of physical substance.* An asset may be contained in or on an item with physical substance, for example, a compact disc in the case of computer software. An asset also may be closely associated with another item that has physical substance, for example, the underlying land in the case of a right-of-way easement. These modes of containment and associated items should not be considered when determining whether or not an asset lacks physical substance.
 - *Nonfinancial nature.* In the context of this Statement, an asset with a nonfinancial nature is one that is not in a monetary form similar to cash and investment securities, and it represents neither a claim or right to assets in a monetary form similar to receivables, nor a prepayment for goods or services.
 - *Initial useful life greater than one year.*
- GASB 51 excludes:
 - Assets acquired or created primarily for the purpose of directly obtaining income or profit.
 - Assets resulting from capital lease transactions reported by lessees.
 - Goodwill created through the combination of a government and another entity.
- Recognition of an intangible asset occurs only if it is considered identifiable. That is when either of the following apply:
 - The asset is separable from the government. That is it can be sold, transferred, licensed, rented, or exchanged.
 - The asset arises from contractual or other legal rights, regardless of whether transferable or separable.
- Specific conditions must be present to recognize internally generated intangibles. Capitalization of costs begins after all of the following criteria are met:
 - Determination of specific objectives of the project and the nature of the service capacity expected upon the completion.
 - Demonstration of the feasibility that the completed project will provide its expected service capacity
 - Demonstration of the current intention, ability, and effort to complete or continue development of the intangible asset.
 - Internally generated computer software is used as an example in applying the specific conditions approach.
- Amortization lives are addressed:
 - Limited by contractual or legal provisions.
 - Renewal periods for rights may be considered if there is evidence that the government will seek and be able to achieve renewal and that any anticipated outlays to be incurred as part of achieving the renewal are nominal. Such evidence should consider the required consent of a third party and the satisfaction of any conditions required to achieve renewal.

CITY OF PALO ALTO

MEMORANDUM ON INTERNAL CONTROL STRUCTURE

SCHEDULE OF OTHER MATTERS

- An indefinite life (no amortization) is permitted so long as there are:
 - No limiting legal, contractual, regulatory, technological, or other factors, and
 - No subsequent change in circumstances.
 - A permanent right-of-way easement is an example.

Retroactive Application. For GASB 34 Phase I & II governments, retroactive reporting is required for intangible assets acquired in fiscal years ending after June 30, 1980. Retroactive reporting is not required for intangible assets with indefinite useful lives or internally generated intangibles, as of the effective date of this Statement.

Management Response:

Staff will work closely with external auditors to prepare for the implementation of GASB 51. Required changes will be incorporated with the FY 2009-10 CAFR.

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

CURRENT STATUS OF PRIOR YEAR OTHER MATTERS

2007-02: Cash Collection Sites – Building Development Center

Current Status: Procedures have been implemented and updated.

2007-03: Utility Connection Fee Billings

Current Status: The upgrade to SAP is currently in process and the Actual Labor Program has been contracted for and is expected to be implemented as of July 1, 2008. An update will be given during yearend audit.

Staff has completed the design and configuration of the Actual Labor Costing Program. Various user groups, such as Payroll staff, Accounting staff, and Project staff, have completed configuration testing using data from a Test Client System. Staff is currently testing the configuration in the current Production System.

2007-04: GASB Statement No. 48 - Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues (effective for Fiscal Year 2007-2008)

Current Status: Implemented

2007-05:- GASB Statement No. 49 - Accounting and Financial Reporting for Pollution Remediation Obligations (Effective for Fiscal Year 2008-2009)

Current Status: No action needed for FY07/08

CURRENT STATUS OF FISCAL 2005-06 RECOMMENDATIONS OUTSTANDING

Information Systems Safeguards

Business Continuity Plan

Current Status: In process, please see the attached Disaster Recovery Plan.

Information Systems Security: Network Communications

Current Status: Staff actively monitors the network, firewall, and associated log files for network vulnerabilities. Staff will be investigating hiring an independent party to perform additional vulnerability tests of our network.

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CITY OF PALO ALTO
REQUIRED COMMUNICATIONS

October 24, 2008

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

We have audited the financial statements of the City of Palo Alto as of and for the year ended June 30, 2008 and have issued our report thereon dated October 24, 2008. Professional standards require that we advise you of the following matters relating to our audit.

Financial Statement Audit Assurance: Our responsibility, as prescribed by professional standards, is to plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit in accordance with generally accepted auditing standards does not provide absolute assurance about, or guarantee the accuracy of, the financial statements. Because of the concept of reasonable assurance and because we did not perform a detailed examination of all transactions, there is an inherent risk that material errors, fraud, or illegal acts may exist and not be detected by us.

Other Information Included with the Audited Financial Statements: Pursuant to professional standards, our responsibility as auditors for other information in documents containing the City's audited financial statements does not extend beyond the financial information identified in the audit report, and we are not required to perform any procedures to corroborate such other information. Our responsibility also includes communicating to you any information that we believe is a material misstatement of fact. Nothing came to our attention that caused us to believe that such information, or its manner of presentation, is materially inconsistent with the information, or manner of its presentation, appearing in the financial statements. This other information and the extent of our procedures is explained in our audit report.

CITY OF PALO ALTO

REQUIRED COMMUNICATIONS

Accounting Policies: Management has the responsibility to select and use appropriate accounting policies. A summary of the significant accounting policies adopted by the City is included in Note 1 to the financial statements. There have been no initial selections of accounting policies and no changes in significant accounting policies or their application during 2008. As described in notes to the financial statements, during the year, the City implemented the following new standards:

- GASB Statement No. 45 - Accounting And Financial Reporting By Employers For Postemployment Benefits Other Than Pensions

GASB 45 uses Pension Accounting (GASB 27) to change the accounting for Other Post Employment Benefits (OPEB) to full accrual at the Entity-wide and proprietary funds financial statement levels. Under the concepts in GASB 45 an actuarial study or simplified measurement method calculation is performed to determine an Annual Required Contribution (ARC). So long as employers contribute this amount every year, no accrual adjustment is needed in the financial statements. A summary of the impacts of this statement are presented below.

As discussed in Note 12 to the financial statements, during the year ended June 30, 2008, the City contributed the ARC for fiscal 2007-08 by paying retiree health care premiums and paying additional contributions to into a separate irrevocable trust established for the sole purpose of funding OPEB. This Trust is governed by a separate board, which is not appointed or controlled by the City Council or management and it has therefore been excluded from the City's financial statements. In addition, the City transferred funds accumulated in prior years (termed the Net OPEB Asset) into the Trust. This Net OPEB Asset has been recorded as an asset and is being amortized over the actuarial amortization period. There was no cumulative effect of the accounting change as of the beginning of the year.

- GASB Statement No. 48 - Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues

This Statement establishes financial reporting of several categories of transactions. There was no cumulative effect on prior year financial statements. However, Note 7 to the financial statements was modified to include disclosures of revenue pledged for repayment of debt.

- GASB Statement No. 50 Pension Disclosures — an amendment of GASB Statements No. 25 and No. 27

This Statement amends current disclosures for cost sharing defined benefit pension plans by requiring among other things, funding trend data for cost sharing pools. Note 8 to the financial statements was modified and enhanced primarily by the inclusion of trend funding tables for the State-wide pools the City participates in.

Unusual Transactions, Controversial or Emerging Areas: No matters have come to our attention that would require us, under professional standards, to inform you about (1) the methods used to account for significant unusual transactions and (2) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. There have been no initial selections of accounting policies and no changes in significant accounting policies or their application during 2008. While there have been no changes in accounting policies or disclosures resulting from the credit crisis, we believe the unprecedented volatility of credit markets occurring after year end warrants mention.

CITY OF PALO ALTO
REQUIRED COMMUNICATIONS

Credit Risk and the Financial Crisis: The City has credit risks in three primary areas of its operations: investments (Note 3), loans receivable (Note 5), and utility commodity counterparties (Note 16 -Utilities Energy Resource Management). Credit risks as of June 30, 2008 for these areas have been disclosed in accordance with generally accepted accounting principals.

However, subsequent to year end, financial markets experienced significant reductions of available credit and certain financial institutions have had their credit ratings downgraded with one large institution entering bankruptcy. The federal government has taken steps to support financial markets in an effort to stave off further negative trends. These conditions have increased credit risks which warrant continuous monitoring and reassessment of the risk that credit counterparties and investees maybe downgraded or be unable to fulfill their obligations. The City should place the highest priority on maintaining a credit watch on its counterparties and formulate contingency plans as needed to ensure credit shortages do not significantly affect its operations.

Estimates: Accounting estimates are an integral part of the financial statements prepared by management and are based on management's current judgments. Those judgments are normally based on knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. The most sensitive accounting estimates affecting the financial statements are discussed below:

- *Estimated Fair Value of Investments* (Note 3 to the financial statements) - As of June 30, 2008, the City held approximately \$375 million of cash and investments as measured by fair value. Fair value is essentially market pricing in effect as of June 30, 2008. These fair values are not required to be adjusted for changes in general market conditions occurring subsequent to June 30, 2008.
- *Allowance for Doubtful Account – Notes Receivable* (Note 5 to the financial statements): The City has loaned approximately \$21 million to other parties to promote its low and moderate income housing programs. As of June 30, 2008, management had established an allowance for collectability of approximately \$14 million based on its estimate of the ultimate likelihood of collection.
- *Accrued Landfill Postclosures Costs* (Note 9 to the financial statements)- The City has estimated post closure costs of a landfill based on what it would cost to perform all currently mandated closure and post-closure care. Actual closure and post-closure care costs may be higher due to inflation variances, changes in technology, or changes in State or Federal regulations.
- *Claims Loss Reserves* (Note 14 to the financial statements)- The City is exposed to a variety of risks of loss due to general liability and workers compensation claims and records an estimate of these losses based on an actuarial study performed by a third party consultant actuary. This study is prepared based on the City's prior claims history which is used as a basis for extrapolating losses for known and incurred but not reported claims. Actual loss experience will vary form estimates.

CITY OF PALO ALTO

REQUIRED COMMUNICATIONS

Disagreements with Management: For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter that could be significant to the City's financial statements or the auditor's report. No such disagreements arose during the course of the audit.

Management informed us that, and to our knowledge, there were no consultations with other accountants regarding auditing and accounting matters.

Retention Issues: We did not discuss any major issues with management regarding the application of accounting principles and auditing standards that resulted in a condition to our retention as the City's auditors.

Difficulties: We encountered no serious difficulties in dealing with management relating to the performance of the audit.

Audit Adjustments: For purposes of this communication, professional standards define an audit adjustment, whether or not recorded by the City, as a proposed correction of the financial statements that, in our judgment, may not have been detected except through the audit procedures performed. These adjustments may include those proposed by us but not recorded by the City that could potentially cause future financial statements to be materially misstated, even though we have concluded that the adjustments are not material to the current financial statements.

We did not propose any audit adjustments that, in our judgment, could have a significant effect, either individually or in the aggregate, on the entity's financial reporting process.

Uncorrected Misstatements: Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. We have no such misstatements to report to the audit committee.

This report is intended solely for the information and use of the City Council, its committees, and management and is not intended to be and should not be used by anyone other than these specified parties.

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**INDEPENDENT AUDITOR'S REPORT ON
COMPLIANCE WITH THE PROPOSITION 111
2007-2008 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, 2008. 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 2007-2008 Appropriations Limit of \$106,683,316 and annual adjustment factors were adopted by resolution of City Council. We also determined that the population and inflation options were selected by a recorded vote of the City Council.
- B. For the Worksheet, we recomputed the 2007-2008 Appropriations Limit by multiplying the 2006-2007 Appropriations Limit by the 2007-2008 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

October 24, 2008

**CITY OF PALO ALTO
PUBLIC IMPROVEMENT CORPORATION
BASIC COMPONENT UNIT FINANCIAL STATEMENTS
FOR THE YEAR ENDED
JUNE 30, 2008**

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<p style="text-align: center;">CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION BASIC COMPONENT UNIT FINANCIAL STATEMENTS FOR THE YEAR ENDED JUNE 30, 2008</p>

Table of Contents

	<u>Page</u>
<i>Independent Auditor's Report</i>	1
<i>Management's Discussion and Analysis.....</i>	3
<i>Financial Statements:</i>	
Government-wide Financial Statements	
Statement of Net Assets	8
Statement of Activities	9
Fund Financial Statements	
Balance Sheet	12
Statement of Revenues, Expenditures and Changes in Fund Balances	13
Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds to the Statement of Activities	14
Notes to Financial Statements.....	15

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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 basic component unit financial statements of the governmental activities and the 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, 2008 as listed in the Table of Contents. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement. An audit includes examining on a test basis evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides 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 the major fund of the Palo Alto Public Improvement Corporation as of June 30, 2008, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles in the United States of America.

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

Maze Associates

October 24, 2008

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MANAGEMENT 'S DISCUSSION AND ANALYSIS

The Palo Alto Public Improvement Corporation, a component unit of the City of Palo Alto, follows the provisions of Government Accounting Standards Board Statement 34 (GASB 34), "Basic Financial Statements-and Management's Discussion & Analysis-for State and Local Governments".

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

FISCAL 2008 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 account gain of \$137 thousand. It also issued its 2002B Downtown Parking Improvements COPs in the amount of \$3.6 million. In fiscal year 2005 a partial redemption was done by placing excess construction and debt service reserve funds into an escrow account to defease \$900 thousand of 2002B downtown Parking Improvements COP's. These issues plus the 1998 Golf Course Capital Improvements COPs issue comprise all its outstanding debt.

Interest expense on these COPs issues was \$401 thousand in fiscal year 2008, a decrease of \$63 thousand from prior year. The interest on leases on the assets securing these COPs issues was \$481 thousand, an increase of \$51 thousand from prior year; the net program and \$13 thousand in interest income resulted in a gain of \$95 thousand in fiscal year 2008, an increase of \$101 thousand from prior year.

The Corporation ended fiscal year 2008 with total assets of \$8.6 million, a decrease of \$0.7 million from prior year. Total assets included \$1.3 million in cash, and \$7.3 million in present value of leases receivable from the City of Palo Alto, a decrease of \$0.7 million from prior year. Total liabilities were \$8.5 million, a decrease of \$0.8 million from prior year, including \$8.4 million in long-term debt.

At the Fund level, the Corporation reported \$14 thousand in revenues over expenditures. Prior year was a negative \$49 thousand for a difference of \$63 thousand.

As of June 30, 2008, the corporation has one fund, Debt Service Fund, which reported a \$1.4 million fund balance, an increase of \$.1 million from prior year.

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 the 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 issued two COPs 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 AGENCY'S FINANCIAL MANAGEMENT

The 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.

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

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

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

The Corporation's Governmental Activities include the activities of its Debt Service Fund.

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

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

PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
STATEMENT OF NET ASSETS
JUNE 30, 2008

ASSETS

Cash and investments held by trustee (Note 3)	\$1,342,553
Interest receivable	12,065
Investment in leases to City of Palo Alto (Note 2C)	<u>7,273,445</u>
Total Assets	<u>8,628,063</u>

LIABILITIES

Interest payable	107,393
Long-term debt (Note 4):	
Due in one year	800,000
Due in more than one year	<u>7,605,000</u>
Total Liabilities	<u>8,512,393</u>

NET ASSETS

Restricted (Note 5A)	<u>115,670</u>
Total Net Assets	<u><u>\$115,670</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 YEAR ENDED JUNE 30, 2008

EXPENSES

Interest and fiscal agent charges	<u>\$400,551</u>
Total Program Expenses	<u>400,551</u>

REVENUES

Interest on leases from City of Palo Alto	<u>480,780</u>
Net Program Expenses	<u>80,229</u>

GENERAL REVENUES

Interest from cash and investments	<u>14,791</u>
Change in Net Assets	95,020
Net assets at the beginning of year	<u>20,650</u>
Net assets at the end of year	<u><u>\$115,670</u></u>

See accompanying notes to financial statements

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FUND FINANCIAL STATEMENTS

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

The Corporation has one fund in fiscal 2008.

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
DEBT SERVICE FUND BALANCE SHEET
JUNE 30, 2008

ASSETS

Cash and investments held by trustee (Note 3)	\$1,342,553
Interest receivable	12,065
Investment in leases to City of Palo Alto (Note 2C)	<u>7,273,445</u>
Total Assets	<u><u>\$8,628,063</u></u>

LIABILITIES

Deferred revenue	<u>\$7,273,445</u>
Total Liabilities	<u>7,273,445</u>

FUND BALANCE (Note 5B)

Reserved for:	
Debt service	<u>1,354,618</u>
Total Fund Balance	<u><u>1,354,618</u></u>

RECONCILIATION OF FUND BALANCE TO NET ASSETS:

Accrual adjustment to remove deferred revenue from the balance sheet	
Deferred revenue	7,273,445
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	(107,393)
Due within one year	(800,000)
Due in more than one year	<u>(7,605,000)</u>
NET ASSETS OF GOVERNMENTAL ACTIVITIES	<u><u>\$115,670</u></u>

See accompanying notes to financial statements

PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
DEBT SERVICE FUND
STATEMENT OF REVENUES, EXPENDITURES
AND CHANGES IN FUND BALANCE
FOR THE YEAR ENDED JUNE 30, 2008

REVENUES

Lease receipts from City of Palo Alto:	
Principal	\$735,231
Interest	480,780
Interest from cash and investments	<u>14,791</u>
 Total Revenues	 <u>1,230,802</u>

EXPENDITURES

Debt service:	
Principal repayment	770,000
Interest and fiscal agent charges	<u>447,005</u>
 Total Expenditures	 <u>1,217,005</u>

NET CHANGE IN FUND BALANCE	13,797
 Fund balance at beginning of year	 <u>1,340,821</u>
Fund balance at end of year	<u><u>\$1,354,618</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, 2008

Net change in fund balances-total governmental funds	\$13,797
Amounts reported for governmental activities in the statement of activities are different because:	
Repayment of bond principal is an expenditure in the governmental funds, but in the Statement of Net Assets the repayment reduces long-term liabilities.	
Fund balance is increased by the amount of debt repayment	770,000
Some amounts reported in the Statement of Revenues, Expenditures and Changes in Fund Balances reflect the collection of an asset which are not includable as revenues on the Statement of Activities	
Change in deferred revenue	(735,231)
Change in interest payable	<u>46,454</u>
Change in net assets of governmental activities	<u><u>\$95,020</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
For the Year Ended June 30, 2008**

NOTE 1 - DESCRIPTION OF REPORTING ENTITY

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

The Corporation is an integral part of the City of Palo Alto. It primarily services the City and its governing body is composed of the City Council. Therefore, the financial data of the Corporation has also been included as a blended component unit within the City's comprehensive annual financial report for the year ended June 30, 2008.

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Presentation

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

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

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

B. Major Funds

Major funds are defined as funds that have either assets, liabilities, revenues or expenditures equal to ten percent of their fund-type total and five percent of the grand total. The Corporation has one fund which is reported as a major governmental fund in the accompanying financial statements:

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

**Notes to Financial Statements
For the Year Ended June 30, 2008**

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

C. *Investment in Leases*

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

A. *Interest Rate Risk*

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

Investment Type	Amount	Maturity Date
CAMP	\$14,168	N/A
U.S. Agency Obligations:		
FNMA	734,886	February 15, 2011
Money Market Mutual Funds	593,499	N/A
Total Investments held by Trustee	<u>\$1,342,553</u>	

California Asset Management Program

The City is a voluntary participant in the California Asset Management Program (CAMP). CAMP is an investment pool offered by the California Asset Management Trust (the Trust). The Trust is a joint powers authority and public agency created by the Declaration of Trust and established under the provisions of the California Joint Exercise of Powers Act (California Government Code Sections 6500 et seq., or the "Act") for the purpose of exercising the common power of its Participants to invest certain proceeds of debt issues and surplus funds. The Pool's investments are limited to investments permitted by subdivisions (a) to (n), inclusive, of Section 53601 of the California Government Code. The City reports its investments in CAMP at the fair value amounts provided by CAMP, which is the same as the value of the pool share. At June 30, 2008 the fair value approximated is the City's cost. At June 30, 2008, these investments have an average maturity of 49 days.

CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
Notes to Financial Statements
For the Year Ended June 30, 2008

NOTE 3 - CASH AND INVESTMENTS HELD BY TRUSTEE (Continued)
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Money Market Mutual Funds are available for withdrawal on demand and at June 30, 2008 and have an average maturity of 17 days.

B. Credit Risk

Generally, credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. This is measured by the assignment of a rating by a nationally recognized statistical rating organization. The actual ratings as of June 30, 2008 for all U.S. Agency Obligations and Mutual funds are Aaa as provided by Moody's Investment Rating system. As an external investment pool, the California Asset Management Program was not rated as of June 30, 2008.

C. Investment Policy

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

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

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

Notes to Financial Statements
For the Year Ended June 30, 2008

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

Authorized Investment Type	Maximum Maturity	Minimum Credit Quality	Maximum Percentage of Portfolio	Maximum Investment In One Issuer
U.S. Government Securities	10 years	N/A	No Limit	No Limit
U.S. Government Agency Securities (C)	10 years	N/A	No Limit (A)	No Limit
Certificates of Deposit	10 years	N/A	20%	10% of the par value of portfolio
Bankers Acceptances	180 days (D)	N/A (D)	30%	\$5 million
Commercial Paper	270 days	AAA	15%	\$3 million (B)
Local Agency Investment Fund	N/A	N/A	No Limit	\$40 million per account
Short-Term Repurchase Agreements	1 year	N/A	No Limit	No Limit
City of Palo Alto Bonds	N/A	N/A	No Limit	No Limit
Money Market Deposit Accounts	N/A	N/A (E)	No Limit	10%
Mutual Funds (F)	N/A	N/A	20%	10%
Negotiable Certificates of Deposit	10 years	N/A	10%	\$5 million
Medium Term Corporate Notes	5 years	AA	10%	\$5 million

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

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

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

Debt Agreements:

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

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

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

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

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

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

**Notes to Financial Statements
For the Year Ended June 30, 2008**

NOTE 4 - CERTIFICATES OF PARTICIPATION

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

	Balance June 30, 2007	Retirements	Balance June 30, 2008	Current Portion
Governmental Activity Debt:				
Certificates of Participation				
1998 Golf Course				
4.00-5.00%, due 09/01/2018	\$5,075,000	\$325,000	\$4,750,000	\$335,000
2002A Civic Center Refinancing				
2.00-4.00%, due 03/01/2012	1,890,000	350,000	1,540,000	365,000
2002B Downtown Parking Improvements				
4.55-6.00%, due 03/01/2022	2,210,000	95,000	2,115,000	100,000
	<u>\$9,175,000</u>	<u>\$770,000</u>	<u>\$8,405,000</u>	<u>\$800,000</u>

In August 1998, the Corporation issued the **Golf Course Capital Improvements and Refinancing Project Certificates of Participation, Series 1998** in the amount of \$7.8 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 the 1978 Bonds.

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 \$3.6 million to finance the construction of certain improvements to the non-parking area contained in the City's Bryant/Florence Garage complex. Principal payments are due annually on March 1 and interest payments semi-annually on March 1 and September 1 and are payable from lease 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
For the Year Ended June 30, 2008**

NOTE 4 - CERTIFICATES OF PARTICIPATION (Continued)

On January 25, 2005, the City defeased \$900 thousand of the 2002B Downtown Parking Improvements Certificates of Participation. The City placed \$1.0 million in surplus cash from the Civic Center Refinancing and Downtown Parking Improvement Project Construction account in an irrevocable trust to provide for future debt payments. Accordingly, the trust account assets and the liability for the defeased Bonds are not included on the financial statements. The outstanding amount of the defeased debt at June 30, 2008 is \$775 thousand. The defeasance resulted in an overall debt service savings of \$1.5 million and an economic gain of \$462 thousand.

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

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

For the Year Ending June 30	Governmental Activities		
	Principal	Interest	Total
2009	\$800,000	\$414,681	\$1,214,681
2010	840,000	380,564	1,220,564
2011	870,000	344,109	1,214,109
2012	905,000	305,559	1,210,559
2013	530,000	263,512	793,512
2014-2018	3,110,000	857,387	3,967,387
2019-2022	1,350,000	148,177	1,498,177
Total	<u>\$8,405,000</u>	<u>\$2,713,989</u>	<u>\$11,118,989</u>

NOTE 5 - NET ASSETS AND FUND BALANCES

A. Net Assets

Net Assets are described below:

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

B. Fund Balances

Fund balances consist of reserved fund balance representing that portion of fund balance which is legally segregated for debt service.

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

FINANCIAL STATEMENTS

**FOR THE YEAR ENDED
JUNE 30, 2008**

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<p style="text-align: center;">CITY OF PALO ALTO REGIONAL WATER QUALITY CONTROL PLANT FINANCIAL STATEMENTS FOR THE YEAR ENDED JUNE 30, 2008</p>
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Table of Contents

	<u>Page</u>
<i>Independent Auditor's Report</i>	1
<i>Financial Statements:</i>	
Statement of Net Expenditures and Net Changes in Commitments	2
Statement of Quarterly Billings.....	3
Notes to Financial Statements	5

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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, 2008 as listed in the table of contents. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

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

In our opinion, the financial statements referred to above present fairly in all material respects the net expenditures and net changes in commitments of the Regional Water Quality Control Plant, and its quarterly billings to the Cities of Mountain View and Los Altos for the year ended June 30, 2008 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.



October 24, 2008

CITY OF PALO ALTO
REGIONAL WATER QUALITY CONTROL PLANT
STATEMENT OF NET EXPENDITURES AND NET CHANGES IN COMMITMENTS
FOR THE YEAR ENDED JUNE 30, 2008

	<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	\$1,074,385	\$406,547	\$124,091	\$543,747
Public outreach	156,874	59,361	18,119	79,394
Permitting and enforcement	901,610	275,759	16,520	609,331
Operations and maintenance	9,851,919	3,727,966	1,137,896	4,986,057
System improvement CIP (Note 2)	2,002,799	757,859	231,323	1,013,617
Total Direct Expenditures	<u>13,987,587</u>	<u>5,227,492</u>	<u>1,527,949</u>	<u>7,232,146</u>
INDIRECT ADMINISTRATIVE EXPENDITURES:				
Source control program	1,104,120	417,799	127,526	558,795
Public outreach	1,333	504	154	675
Permitting and enforcement	511,914	254,546	15,250	242,118
Operations and maintenance	2,241,080	848,025	258,844	1,134,211
Total Indirect Expenditures	<u>3,858,447</u>	<u>1,520,874</u>	<u>401,774</u>	<u>1,935,799</u>
DEBT SERVICE EXPENDITURES:				
Refunding 1990 Series A Bonds	281,853	143,745	21,985	116,123
1999 Wastewater Treatment New Project	546,727	207,155	51,775	287,797
Total Debt Service Expenditures	<u>828,580</u>	<u>350,900</u>	<u>73,760</u>	<u>403,920</u>
TOTAL EXPENDITURES	18,674,614	7,099,266	2,003,483	9,571,865
DEDUCT JOINT SYSTEMS REVENUES (Note 5)	<u>(250,418)</u>	<u>(94,758)</u>	<u>(28,923)</u>	<u>(126,737)</u>
NET EXPENDITURES	18,424,196	7,004,508	1,974,560	9,445,128
ADD NET CHANGES IN COMMITMENTS (Note 1)	<u>467,460</u>	<u>176,887</u>	<u>53,992</u>	<u>236,581</u>
NET EXPENDITURES AND NET CHANGES IN COMMITMENTS DUE FROM MEMBERS	<u>\$18,891,656</u>	<u>\$7,181,395</u>	<u>\$2,028,552</u>	<u>\$9,681,709</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, 2008

	<u>City of Mountain View</u>	<u>City of Los Altos</u>
BILLINGS BY QUARTER BEGINNING:		
July 1, 2007	\$1,796,729	\$459,891
October 1, 2007	1,894,141	480,323
January 1, 2008	1,796,729	459,891
April 1, 2008	<u>2,049,723</u>	<u>513,073</u>
 Total quarterly billings	 7,537,322	 1,913,178
 Net expenditures and net changes in commitments	 <u>7,181,395</u>	 <u>2,028,552</u>
 Excess of net expenditures and net changes in commitments over total billings	 <u>\$355,927</u>	 <u>(\$115,374)</u>

See notes to financial statements

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**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 \$2,826,828 at June 30, 2008 less commitments of \$2,359,368 at June 30, 2007. 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.

<p align="center">CITY OF PALO ALTO REGIONAL WATER QUALITY CONTROL PLANT NOTES TO FINANCIAL STATEMENTS</p>

<p>NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES (Continued)</p>
--

The percentages used for the year ended June 30, 2008 to allocate expenditures, commitments and revenues were:

	City of Mountain View	City of Los Altos	City of Palo Alto
Public Outreach, operations and maintenance system improvement CIP, commitments and joint system revenues	37.84%	11.55%	50.61%
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	37.51%	2.25%	60.24%

The City is allocated 50.61% 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 2007-2008 allocations are as follows:

East Palo Alto Sanitary District	7.18%
Stanford University	5.98%
Town of Los Altos Hills	1.20%
Remaining City percentage	36.25%
Total	<u>50.61%</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.

<p>NOTE 2 - SYSTEM IMPROVEMENT CIP (MINOR CAPITAL)</p>

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 \$2,002,798 for fiscal year 2007-2008.

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

NOTE 3 - INDIRECT ADMINISTRATION EXPENDITURES

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

NOTE 4 - DEBT SERVICE EXPENDITURES

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

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

At June 30, 2008, the outstanding principal of the 1999 Series A Bonds relating to the rehabilitation of the Wastewater Treatment system's sludge incinerators (1999 Wastewater Treatment New Project) and to refund the 1990 Series A Bonds amounted to \$8,692,310.

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

	1999 Wastewater Treatment New Project	Refunding of 1990 Series A Bonds	Total
City of Palo Alto	\$2,173,212	\$749,328	\$2,922,540
City of Mountain View	2,157,835	1,528,627	3,686,462
City of Los Altos	539,317	233,790	773,107
East Palo Alto Sanitary District	435,098	356,680	791,778
Stanford University	299,557	122,890	422,447
Town of Los Altos Hills	89,981	5,995	95,976
Total	<u>\$5,695,000</u>	<u>\$2,997,310</u>	<u>\$8,692,310</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.

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

NOTE 5 – JOINT SYSTEM REVENUES

The plant's joint system revenues for the year ended June 30, 2008, totaled \$250,418. This consisted of \$15,000 for salt water marsh services, \$56,818 from the City's Water Fund for lab services, \$151,520 for septic tank hauling services and \$22,080 for a decrease in the bad debt provision.

NOTE 6 - RELATED PARTY TRANSACTIONS

During fiscal 2008, the Plant paid the City \$2,218,499 for utility costs. Such costs are included in the statements of net expenditures and net changes in commitments as source control program, permitting and enforcement and operations and maintenance expenditures.

Vehicle replacement charges of \$33,370 were paid to the City of Palo Alto Equipment Replacement Fund. Of the total \$30,620 and \$2,750 are included in the statement of net expenditures and net changes in commitments as operations and maintenance expenditures, and enforcement respectively.

CABLE TV FRANCHISE
STATEMENTS OF FRANCHISE
REVENUES AND EXPENDITURES
FOR THE YEARS ENDED
DECEMBER 31, 2007 AND 2006

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<p style="text-align: center;">CABLE TV FRANCHISE STATEMENT OF FRANCHISE REVENUES AND EXPENDITURES FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006</p>
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Table of Contents

	<u>Page</u>
<i>Independent Auditor's Report</i>	1
<i>Financial Statement:</i>	
Statement of Franchise Revenues and Expenditures	2
Notes to Financial Statement	3

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INDEPENDENT AUDITOR'S REPORT

The Members of the
Cable TV Franchise

We have audited the accompanying Statement of Franchise Revenues and Expenditures of the Cable TV Franchise (Franchise) for the years ended December 31, 2007 and 2006 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 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 to the financial statement, the statement 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 statement referred to above presents fairly in all material respects the revenues and expenditures of the Franchise for the years ended December 31, 2007 and 2006 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.



October 24, 2008

CABLE TV FRANCHISE
STATEMENT OF FRANCHISE REVENUES AND EXPENDITURES
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

	<u>2007</u>	<u>2006</u>
REVENUES:		
Franchise fees	<u>\$1,273,879</u>	<u>\$1,161,007</u>
Total Receipts	<u>1,273,879</u>	<u>1,161,007</u>
EXPENDITURES:		
Franchise administration	62,506	40,978
Consulting fees	<u>30,035</u>	<u>12,136</u>
Total Expenditures	<u>92,541</u>	<u>53,114</u>
Net Receipts	<u><u>\$1,181,338</u></u>	<u><u>\$1,107,893</u></u>

DISTRIBUTED NET RECEIPTS:

	<u>2007</u>		<u>2006</u>	
	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Allocation of Net Receipts:				
City of Palo Alto	\$592,600	50%	\$554,310	50%
City of Menlo Park	295,054	25%	278,226	27%
City of East Palo Alto	120,867	10%	119,970	11%
Town of Atherton	85,223	7%	74,665	7%
County of Santa Clara	63,691	6%	58,456	3%
County of San Mateo	<u>23,903</u>	<u>2%</u>	<u>22,266</u>	<u>2%</u>
Total	<u><u>\$1,181,338</u></u>	<u><u>100%</u></u>	<u><u>\$1,107,893</u></u>	<u><u>100%</u></u>

See accompanying notes to financial statements

**STATEMENT OF FRANCHISE
CABLE TV FRANCHISE
REVENUE AND EXPENDITURES
Notes to Financial Statement
For the Years Ended December 31, 2007 and 2006**

NOTE 1 - JOINT OPERATING AGREEMENT AND BASIS OF ACCOUNTING

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

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

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

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

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

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

NOTE 2 - PRIOR FRANCHISE SETTLEMENTS

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

**STATEMENT OF FRANCHISE
CABLE TV FRANCHISE
REVENUE AND EXPENDITURES
Notes to Financial Statement
For the Years Ended December 31, 2007 and 2006**

NOTE 2 - PRIOR FRANCHISE SETTLEMENTS (Continued)

On July 24, 2000, the City reached a settlement with CCCOPA in the amount of \$220,000 to resolve outstanding claims resulting from CCCOPA's alleged failure to fully perform under the prior Franchise Agreement. The City will work with the Members to develop a plan for utilization of the settlement.

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

These amounts have been deposited and are being held by the City and are earning interest. As of December 31, 2007, the total amount on deposit was \$797,261.

**REDEVELOPMENT AGENCY OF
THE CITY OF PALO ALTO
BASIC COMPONENT UNIT FINANCIAL STATEMENTS
FOR THE YEAR ENDED
JUNE 30, 2008**

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**REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
BASIC COMPONENT UNIT FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2008**

TABLE OF CONTENTS

	<u>Page</u>
FINANCIAL SECTION:	
<i>Independent Auditor's Report</i>	1
<i>Management's Discussion and Analysis</i>	3
<i>Component Unit Financial Statements:</i>	
Agency-wide Financial Statements:	
Statement of Net Assets	5
Statement of Activities	6
Fund Financial Statements:	
Balance Sheet	8
Statement of Revenues, Expenditures, and Changes in Fund Balance	9
Statement of Revenues, Expenditures, and Changes in Fund Balances - Budget and Actual	10
Notes to Basic Component Unit Financial Statements	11
<i>Report on Compliance and on Internal Control over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards</i>	15

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INDEPENDENT AUDITOR'S REPORT ON THE FINANCIAL STATEMENTS

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

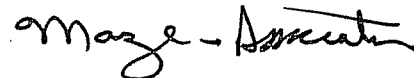
We have audited the accompanying component unit financial statements of the governmental activities and major fund of the Redevelopment Agency of the City of Palo Alto, a component unit of the City of Palo Alto, as of and for the year ended June 30, 2008, as listed in the Table of Contents. These component 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 our report dated, October 24, 2008 on our consideration of the Agency's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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, 2008 and the changes in financial position for the year then ended, in conformity with generally accepted accounting principles in the United States of America.

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



October 24, 2008

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MANAGEMENT'S DISCUSSION AND ANALYSIS

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

FISCAL 2008 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 2008, the Agency incurred on-going costs in the amount of \$6 thousand, the same as prior year. The Agency received a transfer from the City of Palo Alto in the amount \$6 thousand to fund these costs, the same as prior year. As of June 30, 2008, the Agency had not yet adopted a project area nor received any tax increment revenues.

OVERVIEW OF THE AGENCY'S BASIC FINANCIAL STATEMENTS

The Basic Financial statements are in two parts:

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

The Basic Financial Statements

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

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

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

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

ECONOMIC OUTLOOK AND MAJOR INITIATES

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

CONTACTING THE AGENCY'S FINANCIAL MANAGEMENT

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

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
A COMPONENT UNIT OF THE CITY OF PALO ALTO
STATEMENT OF NET ASSETS
JUNE 30, 2008

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, 2008

EXPENSES

Planning and Community Reimbursements to the City	<u>(\$6,000)</u>
---	------------------

Change in Net Assets	(6,000)
----------------------	---------

GENERAL REVENUES

Transfer from the City of Palo Alto	<u>6,000</u>
-------------------------------------	--------------

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

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

See accompanying notes to financial statements

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 2008.

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, 2008

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

See accompanying notes to financial statements

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
A COMPONENT UNIT OF THE CITY OF PALO ALTO
STATEMENT OF REVENUES, EXPENDITURES
AND CHANGES IN FUND BALANCE
FOR THE YEAR ENDED JUNE 30, 2008

	<u>General Fund</u>
OTHER FINANCING SOURCES (USES)	
Transfer in from the City of Palo Alto (Note 2)	\$6,000
Transfer (out) to the City of Palo Alto (Note 2)	<u>(6,000)</u>
Fund balance at beginning of year	<u> </u>
Fund balance at end of year	<u><u> </u></u>

See accompanying notes to financial statements

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
A COMPONENT UNIT OF THE CITY OF PALO ALTO
STATEMENT OF REVENUES, EXPENDITURES
AND CHANGES IN FUND BALANCE - BUDGET AND ACTUAL
GENERAL FUND
FOR THE YEAR ENDED JUNE 30, 2008

	<u>Budgeted Amount</u>		<u>Actual Amount</u>	<u>Variance with</u>
	<u>Adopted</u>	<u>Adjusted</u>	<u>Budgetary Basis</u>	<u>Final Budget</u>
				<u>Positive</u>
				<u>(Negative)</u>
OTHER FINANCING SOURCES (USES)				
Transfer in from the City of Palo Alto	\$9,000	\$9,000	\$6,000	(3,000)
Transfer out to the City of Palo Alto	<u>(9,000)</u>	<u>(9,000)</u>	<u>(6,000)</u>	<u>3,000</u>
Total Other Financing Sources (Uses)	<u><u> </u></u>	<u><u> </u></u>	<u> </u>	<u><u> </u></u>
Fund balance at beginning of year			<u> </u>	
Fund balance 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 Basic Component Unit Financial Statements

For the Year Ended June 30, 2008

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING 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 blended component unit of the basic financial statements prepared by the City. A component unit is a separate governmental unit, agency or nonprofit corporation which, when combined with all other component units, constitutes the reporting entity as defined in the City's basic financial statements.

B. *Basis of Presentation*

The Agency's Basic Component Unit 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 United States of America.

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

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

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

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

C. *Major Funds*

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

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
Notes to Basic Component Unit Financial Statements
For the Year Ended June 30, 2008

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

REDEVELOPMENT AGENCY GENERAL FUND

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

D. Basis of Accounting

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

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

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

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

E. Budgets and Budgetary Accounting

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

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

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

F. Net Assets

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

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

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
Notes to Basic Component Unit Financial Statements
For the Year Ended June 30, 2008

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNT POLICIES (Continued)

G. *Fund Balances, Reserves and Designations*

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

NOTE 2 – TRANSACTIONS WITH THE CITY

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

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

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

We have audited the financial statements of the Redevelopment Agency of the City of Palo Alto as of and for the year ended June 30, 2008, and have issued our report thereon dated October 24, 2008. We have conducted our audit in accordance with generally accepted auditing standards in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Agency's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Agency's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Agency's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Agency's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Agency's financial statements that is more than inconsequential will not be prevented or detected by the Agency's internal control.

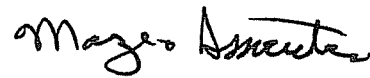
A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Agency's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the second paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. As part of our audit, we prepared and issued our separate Memorandum on Internal Control dated October 24, 2008.

Compliance and Other Matters

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

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



October 24, 2008