

## **CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR**

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

**December 14, 2004**

### **Maze & Associates' Audit of the City of Palo Alto's Financial Statements as of June 30, 2004 and Management Letter**

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

#### **Discussion**

The City Charter requires the City Council (through the City Auditor) to engage an independent certified public accounting firm to conduct the annual external audit and report the results of the audit in writing to the City Council. Maze & Associates, an accountancy corporation based in Walnut Creek, California, conducted the audit of the City's financial statements as of June 30, 2004. The Independent Auditor's Report (the "opinion letter") and Single Audit Report (the audit of federal funds received by the City) are included in the Comprehensive Annual Financial Report for the fiscal year ended June 30, 2004.

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

- Memorandum on Internal Control Structure for the year ended June 30, 2004 (the "management letter") – Attachment A
- Independent Auditor's Report on Compliance with the Proposition 111 2003-04 Appropriation Limit Increment (the "Gann limit letter") – Attachment B
- Public Improvement Corporation Component Unit Financial Statements for the year ended June 30, 2004 – Attachment C
- Regional Water Quality Control Plant Financial Statements for the year ended June 30, 2004 – Attachment D
- Cable TV Franchise Statements of Revenues and Expenditures for the years ended December 31, 2003 and 2002 – Attachment E
- Bicycle/Pedestrian Projects Financial Statements for the years ended June 30, 2004 and 2003 – Attachment F
- Redevelopment Agency of the City of Palo Alto Component Unit Financial Statements for the year ended June 30, 2004 – Attachment G

Cory Biggs from Maze & Associates will be available at the December 14<sup>th</sup> Finance Committee meeting to answer questions. We would like to thank the Administrative Services Department for their hard work to ensure a clean audit.

Respectfully submitted,

A handwritten signature in cursive script that reads "Sharon W. Erickson".

Sharon W. Erickson  
City Auditor

**CITY OF PALO ALTO  
MEMORANDUM ON  
INTERNAL CONTROL STRUCTURE  
FOR THE YEAR ENDED JUNE 30, 2004**

# MAZE & ASSOCIATES

October 22, 2004

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

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

As part of our audit of the financial statements of the City of Palo Alto for the year ended June 30, 2003, we considered the City's internal control structure in determining the scope of our audit procedures for the purpose of rendering an opinion on the financial statements. While our purpose was not to provide assurances on the internal control structure, certain matters came to our attention that we want to report to you. These matters, along with our recommendations, are described in the accompanying memorandum.

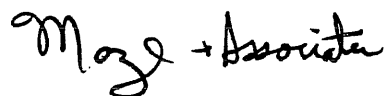
A material weakness is a significant deficiency in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited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

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

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

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

Very truly yours,



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

**New Accounting Standards for Other Post Employment Benefits (OPEB)**

Governmental Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, addresses how state and local governments account for and report postemployment healthcare and other nonpension benefits. The statement generally requires that state and local governmental employers account for and report the annual cost of OPEB and the outstanding obligations and commitments related to OPEB in essentially the same manner as they currently do for pensions.

To comply with these new rules, which take affect in fiscal 2007-08 for the City, require the determination of an actuarial accrued liability (future obligation) to pay for OPEB. An actuarially based funding plan will need to be determined to ensure the City accumulates funds to pay for these obligations. So long as the City sets aside funds using this basis, there will be no impact on the City's financial statements.

Although there are several years before these new rules take effect, they will change the way costs are recognized for OPEB. We understand the City had an actuary study performed in prior years to determine the costs of these benefits. The study should be reviewed to determine if it complies with the actuarial assumptions and methods specified in Statement 45. Provided the study is complete and GASB 45 compliant, the City should begin incorporate the funding of these benefits into its budgets and long-term projections.

**Management Response:**

Staff will work closely with auditors to prepare for implementation of GASB 45. Staff has attended training to understand the implications. Staff is currently drafting a RFP for an Actuarial Study to determine a base line for analysis.

**New Cash and Investment Disclosures for Next Year**

The Governmental Accounting Standards Board has issued Statement #40, *Deposit and Investment Risk Disclosures - an amendment of GASB Statement No. 3*, which is effective for fiscal 2004-2005. These new rules change cash and investment disclosures for municipalities and require the presentation of new data. Although the rules do not take effect until next year, we have included a summary here for your use in the coming year to ensure needed data will be ready. A summary of changes are presented below:

- *Cash in Financial Institutions* - Under the current rules, the City's cash is required to be allocated and disclosed under 3 categories differentiating the degree of custodial risk. Under the new rules, only those cash balances falling into the highest degree of custodial risk (uninsured and uncategorized cash) need to be disclosed. These reduced disclosures will not require a change in what has been assembled in past years.
- *Investment Custodial Risk* - Under the current rules, the City's investments are required to be allocated and disclosed under 3 categories differentiating the degree of custodial risk. Under the new rules, only those investments falling into the highest degree of custodial risk (uninsured and unregistered cash) need to be disclosed.

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- *Concentrations of Credit Risks* – The City will need to assemble information about the concentration of credit risks associated with its investments. For investments in any one issuer that represent 5 percent or more of total investments the City is required to disclose the aggregate amount and issuer name. Investments issued or explicitly guaranteed by the U.S. government and investments in mutual funds, external investment pools, and other pooled investments are excluded from this requirement.
- *Component Unit and Fund Level Concentrations* - The disclosures should be made for the City, including its blended component units. Risk disclosures should also be made for governmental and business-type activities, individual major funds, nonmajor funds in the aggregate, or fiduciary fund types when the risk exposures are significantly greater than the deposit and investment risks of the City. For example, a City's total investments may not be exposed to concentration risk. However, if the City's capital projects fund has all of its investments in one issuer of corporate bonds, disclosure should be made for the capital projects fund's exposure to a concentration of credit risk.
- *Credit Risk Quality* – The City will need to disclose the credit quality ratings of investments in debt securities as of year-end. Investments of the same type and rating may be aggregated for this purpose. Unless there is information to the contrary, obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk and do not require disclosure of credit quality. Governments should disclose the credit quality ratings of external investment pools, money market funds, bond mutual funds, and other pooled investments of fixed-income securities in which they invest. If a credit quality disclosure is required and the investment is unrated, the disclosure should indicate that fact.
- *Interest Rate Risk*- The City will need to disclose information about the interest rate risk of their debt investments by using one of several a disclosure methods. The City will also need to disclose the terms of investments with fair values that are highly sensitive to changes in interest rates. The City is encouraged to use the method that is consistent with the method it uses to manage interest rate risk. Methods suggested include segmented time distributions, the specific identification method, weighted average maturity, duration and simulation models.

Governments with investments in mutual funds, external investment pools, or other pooled investments that do not meet the definition of a 2a7-like pool should disclose interest rate risk information according to one of the methods above.

- *Policy Disclosures* - If a government has an exposure to a concentration of credit risk, an investment policy disclosure regarding concentration of credit risk is required, or if a government has an investment denominated in a foreign currency, an investment policy disclosure regarding foreign investments is required. If a government has no deposit or investment policy that addresses a specific type of risk that it is exposed to, the disclosure should indicate that fact.
- *Investments Sensitive to Interest Rate Change* – GASB #40 requires certain disclosures for investment fair values that are highly sensitive to changes in interest rates. Although seemingly a simple issue, this can be in fact difficult to determine as some investments have hidden derivative features. The City will need to closely examine its investments with fiscal agents to determine if any investments fit the above requirements and require disclosure.

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- *Foreign Currency Risk* – A City's deposits or investments exposed to foreign currency risk should disclose the U.S. dollar balances of such deposits or investments, organized by currency denomination and, if applicable, investment type.

**Management Response:**

Staff will work closely with auditors during interim audit of FY 04-05 to assemble needed data for implementation. Required changes will be incorporated with FY 04-05 CAFR.

**Audit Area of Special Emphasis - Golf Course**

*Procedures and Observations* - As part of our June 30, 2004 audit, we met with staff from the Administrative Services and City Auditor Departments to discuss the special emphasis areas for this years audit. We also included feedback we received from our prior year meeting with the Finance Committee in our plans. Based on the above, the City requested that we look into the procedures followed with respect to the Department of Community Services, Parks and Golf Division Policies/Procedures – Municipal Golf Course Cash Handling Procedures. We obtained a copy of that document and the following:

- Management Agreement between the Golf Shop and the City
- Golf Shop Written Closing Procedures
- Golf Shop key, safe and code logs
- Draft of Suggested Changes to the Courtesy Play Section
- Staff Comp Golf Log, used to track City employees complimentary rounds of golf

We reviewed these documents and met with the PGA Head Professional and the Golf Shop Bookkeeper. We observed Golf Shop cash handling procedures and compared practices against the requirements of the above documents.

*Transactions Tests* - We also selected 15 days spread through out 10 months of fiscal 2003-2004 for revenue testing. Revenues for each of the selected days were traced to Point of Sale reports (Z-tapes) and credit card terminal reports. These revenues traced up through to the monthly Sales Summary Reports provided to the Parks and Golf Division of the City. We traced Rental Revenues from each of our 15 days through to the applicable Lease Management Rent Sheet used to calculate rent to be paid to the City. We further traced Green fees, Play card Sales and Tournament fees through bank accounts specified in the Agreement and to deposit to the City.

*Golfers* - Independently from the above, we sent two of our employees play golf as members of the general public to observe procedures from the customer's point of view.

*Recommendations* -Based on our tests and observations, we noted the following:

- Although it is a policy of the Golf Course, our two Golfers that played at the golf course in June 2004 were not provided a receipt until they requested one. The Policy should be strictly enforced to ensure all sales are entered into the registers.

**CITY OF PALO ALTO**  
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- The Golf Course does not have a 9-hole golf fee, however golf carts may be rented for only 9 holes. Our two Golfers purchased two rounds of 18 holes each and rented a golf cart for only 9 holes. After playing the first 9 holes, our Golfers proceeded on to the 10<sup>th</sup>, 11<sup>th</sup> and 12<sup>th</sup> holes with the golf cart and were not questioned. Golf Course staff should periodically verify that customers with carts have paid the proper rental fee in accordance with their use.
- The Golf Course offers a discount rate for seniors that are also Palo Alto residents. Our two Golfers observed a senior purchasing a round of golf at the discount rate with only verbal verification of his residency. Golf Course staff should verify customer residency through a driver's license or ID card, prior to giving the discount.
- Golf cart rentals requires only a signature and printed name. The Golf Course should consider requiring staff to review golfers driver's licenses for verification, and possibly record the license number. This practice could provide the golf course with valuable information in the event the golfer damages the golf cart.
- We obtained the City Staff Comp Golf Logs for May through July 2004 and noted that two names were listed on the log on 6/16/04 that were not City employees, per our conversation with the City's payroll accountant.
- Employees working at the golf shop are not assigned their own cash register drawer. One employee should be responsible for his or her own drawer. Each drawer should be counted and put in the safe at the end of each shift. This approach limits responsibility for any cash shortages to the individual employee.
- Golf Employee Access: Presented below is a list of golf employee access
  - i. Ten employees have keys to the Pro Shop
  - ii. Nine have access to the Security alarm code
  - iii. Nine have access to the Safe Combination

The number of golf employees with access appears excessive. However, we believe these areas require further follow-up to determine which of these areas affects the City revenue interests those that do, should be evaluated from an operational perspective to determine if all employees with access need it.

Our transactions testing did not disclose errors or reportable conditions. We have however, provided copies of our workpapers to the City Auditor for her review. There may be additional tests she deems important for further tests. For example, we did not observe cash transfers to the Bank Courier, nor register closing procedures. We did not recalculate monthly rents due.

**Management Response:**

**Receipts:** The Brad Lozares Golf Shop (BLGS) cash handling procedures requires staff to provide register receipts to customers for all cash, check and credit card transactions. A review of these required procedures has been made and an internal memorandum will be issued immediately to all staff members reminding them to follow procedures for every transaction with no exception. BLGS management will regularly monitor this mandate.

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**9 Hole Golf Cart Rental:** The majority of golf cart rentals (92%) are for 18 holes of play. Occasionally customers rent carts for nine holes of play after completing the first nine. BLGS and City staff will review cart rental procedures. Based on the low numbers of nine-hole cart rentals, the risk of abuse is minimal.

**Customer Residency:** BLGS is knowledgeable of the Palo Alto residency verification process. A utility bill or drivers license is verified when residents purchase their yearly ID cards. In most instances, ID is not required for many senior discount card golfers due to familiarity amongst staff. When customers request a new monthly play card, there is a residency verification process. A reminder of the residency procedure will be made by internal memorandum and will be distributed to all BLGS employees immediately.

**Liability for Cart Rentals:** BLGS holds exclusive liability for all golf cart leases and insurance requirements as well as maintenance and repairs. The City bears no responsibility for the expense of any golf cart damage. Only four incidents have occurred in 22 years of operations. BLGS is satisfied that the penned signature, name and date on the daily cart rental agreement is sufficient identification.

**Complementary Rounds of Golf:** As part of an industry standard, and in accordance with City-approved procedures, BLGS honors complementary rounds of golf for a limited number of City employees associated with golf course operations and PGA/GCS members (golf pro and superintendents). Separate ledgers are kept for the two groups. After review, findings showed that staff recorded the complementary rounds in the City employee ledger by mistake. A reminder to enter the names under the correct ledger will be made by internal memorandum and will be distributed to all BLGS employees immediately.

**Cash Registers:** BLGS is solely responsible for any discrepancy in cash register receipts. The cashiering system has a transaction numbering process that tracks transactions for reconciliation. The City is fully compensated for any discrepancies found during the reconciliation process.

**Pro Shop Access:** BLGS is solely responsible for any discrepancies in cash or good. BLGS operates sunrise to sunset, three hundred and sixty five days a year, servicing over 125,000 customers. Due to the long hours of operations, equating to over five thousand four hundred and twenty hours per year, with an average of eight staff members per day, it would be difficult to implement a change in practice without a severe impact to customer service. Therefore, BLGS believes the current roster of employees with access to the pro shop alarm and safe combinations is warranted to provide the highest levels of service to our customers.

**System Implementation Issues**

Fiscal 2003-04 was the first year under the City's new SAP system. This system implementation was in general successful, however, there were a variety of transitional issues we noted in our audit which arose during the year. These included:

- Unlimited payroll system access by the Payroll Department which defeats the concept of strong segregation of duties. We communicated this issue to staff during the interim phase of our work and informed the City Auditor who was aware of the issue.



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- Bank reconciliation system problems with which delayed the completion of the bank reconciliation in March 2004, a key control function.
- Purchasing system problems which required the preparation of multiple journal entries to correct coding errors.

By the time we returned to perform our year-end phase, the issues had been resolved or corrected. Our tests of the bank reconciliations and purchasing transactions did not reveal errors after the corrections to the system were made by staff. However, we believe system access issues should be reviewed further now that the implementation has been completed. Verification of employee access should be performed by review of Information Technology profiles and roles.

**Management Response:**

All corrections related to system implementation were completed by year-end as noted. Adjustment of access by the Payroll Department was completed by the Accounting Manager, a review of the current access has been requested by the Internal Auditor's department.

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

**STATUS OF PRIOR YEAR RECOMMENDATIONS**

**Recommendation #03-1 – Recording Loans Receivable**

**Status:** Implemented

**Recommendation #03-2 – Lucie Stern Community Center Cash Collections**

**Status:** In process

**Recommendation #03-3 – Investment Activity Report**

**Status:** Implemented

**Recommendation #03-4 – Mutual Fund Investments in City's Pooled Cash and Fiscal Agent Accounts**

**Status:** Implemented

**Recommendation #03-5 – Investment Policy**

**Status:** Implemented

**Recommendation #03-5 – Worker's Compensation Account Outstanding Checks**

**Status:** Implemented

**Recommendation #03-6 - Schedule of Expenditures of Federal Awards**

**Status:** Implemented

**Recommendation #03-7- Appropriations Limit Resolution**

**Status:** Implemented

**Recommendation #03-8 Appropriations Limit Compliance Calculation**

**Status:** Implemented

**Recommendation #03-9 Redevelopment Agency Dissolution**

**Status:** Under review

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**INDEPENDENT AUDITOR'S REPORT ON  
COMPLIANCE WITH THE PROPOSITION 111  
2003-2004 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, 2004. 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 2003-2004 Appropriations Limit of \$85,816,708 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 2003-2004 Appropriations Limit by multiplying the 2002-2003 Appropriations Limit by the 2003-2004 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*

April 1, 2004

**CITY OF PALO ALTO  
PUBLIC IMPROVEMENT CORPORATION  
COMPONENT UNIT FINANCIAL STATEMENTS**

**FOR THE YEAR ENDED  
JUNE 30, 2004**

<p style="text-align: center;"><b>CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION COMPONENT UNIT FINANCIAL STATEMENTS FOR THE YEAR ENDED JUNE 30, 2004</b></p>
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## INDEPENDENT AUDITOR'S REPORT

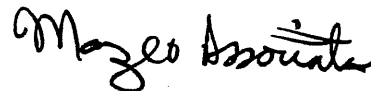
The Honorable Mayor and  
Members of the City Council of the  
City of Palo Alto, California

We have audited the accompanying component unit financial statements of the governmental activities and each major fund of the Palo Alto Public Improvement Corporation, a component unit of the City of Palo Alto, as of and for the year ended June 30, 2004 as listed in the Table of Contents. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly in all material respects the financial position of the governmental activities and each major fund of the Palo Alto Public Improvement Corporation as of June 30, 2004, 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 supplementary information required by the Government Accounting Standards Board, but is not part of the basic financial statements. We have applied certain limited procedures to this information, principally inquiries of management regarding the methods of measurement and presentation of this information, but we did not audit this information and we express no opinion on it.



October 19, 2004

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

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

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

### **FISCAL 2004 FINANCIAL HIGHLIGHTS-CORPORATION-WIDE BASIS AND FUND BASIS**

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

In fiscal year 2002, the Corporation issued its 2002A Civic Center Refinancing COPs in the amount of \$3.5 million to refund its 1992 Civic Center Project COPs, reducing debt service requirements by \$372 thousand and producing an accounting gain of \$137 thousand. It also issued its 2002B Downtown Parking Improvements COPs in the amount of 3.55 million. These issues plus the 1998 Golf course Capital Improvements COPs issue comprise all its outstanding debt.

Interest expense on these COPs issues was \$522 thousand in fiscal year 2004, an increase of \$35 thousand from prior year. The interest on leases on the assets securing these COPs issues was \$499 thousand, and increase of \$62 thousand from prior year; this revenue and \$52 thousand in interest income resulted in an income of \$28 thousand in fiscal year 2004, a decrease of \$5 thousand from prior year.

The Corporation ended fiscal year 2004 with total assets of \$12.4 million a decrease of \$1.5 million from prior year. Total assets included \$2.5 million in cash, a decrease of \$1.5 million from prior year and \$7.4 million in present value of leases receivable from the City of Palo Alto, a decrease of \$.5 million from prior year. It had liabilities of \$12.4 million a decrease of \$0.7 million from prior year, including \$12.2 million in long-term debt.

At the Fund level, the Corporation reported a negative \$1.4 million excess of revenues over expenditures, which was principally due to the construction expenditures financed by the 2002B

Downtown Parking Improvements Certificates of Participation bond proceeds. Prior year was a negative \$1.2 for a difference of \$0.2.

As of June 30, 2004, the Corporation has two funds, Debt Service Fund, which reported a \$1.4 million fund balance and the Capital Projects Fund, which reported a \$1.0 million fund balance a decrease from prior year of \$0.2 and \$1.2 respectively.

## **OVERVIEW OF THE AGENCY'S BASIC FINANCIAL STATEMENTS**

The Basic Financial statements are in two parts:

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

### **The Basic Financial Statements**

The Basic Financial Statements comprise the Corporation-wide Financial Statements and the Fund Financial Statements. These two sets of financial statements provide two different views of the Corporation's financial activities and financial position-long-term and short-term.

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

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

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

## **DEBT ADMINISTRATION**

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

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



## **ECONOMIC OUTLOOK AND MAJOR INITIATES**

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

## **CONTACTING THE AGENCY'S FINANCIAL MANAGEMENT**

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

**CITY OF PALO ALTO - PUBLIC IMPROVEMENT CORPORATION**

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

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

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

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

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

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

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

PALO ALTO PUBLIC IMPROVEMENT CORPORATION  
A COMPONENT UNIT OF THE CITY OF PALO ALTO  
STATEMENT OF NET ASSETS  
JUNE 30, 2004

ASSETS

Cash and investments held by trustee (Note 3)	\$2,452,200
Interest receivable	11,363
Construction in progress	2,534,498
Investment in leases to City of Palo Alto (Note 2E)	<u>7,427,521</u>
Total Assets	<u>12,425,582</u>

LIABILITIES

Interest payable	199,219
Long-term debt (Note 4):	
Due in one year	720,000
Due in more than one year	<u>11,495,000</u>
Total Liabilities	<u>12,414,219</u>

NET ASSETS

Unrestricted	<u>11,363</u>
Total Net Assets	<u><u>\$11,363</u></u>

See accompanying notes to financial statements

PALO ALTO PUBLIC IMPROVEMENT CORPORATION  
A COMPONENT UNIT OF THE CITY OF PALO ALTO  
STATEMENT OF ACTIVITIES  
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

EXPENSES	
Interest and fiscal agent charges	<u>\$522,445</u>
Total Program Expenses	<u>522,445</u>
REVENUES	
Interest on leases from City of Palo Alto	<u>498,812</u>
Net Program Expenses	<u>(23,633)</u>
GENERAL REVENUES	
Interest from cash and investments	<u>51,542</u>
Change in Net Assets	27,909
Net assets at the beginning of year	<u>(16,546)</u>
Net assets at the end of year	<u><u>\$11,363</u></u>

See accompanying notes to financial statements

## FUND FINANCIAL STATEMENTS

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

All of the Corporation's Funds were determined to be Major Funds fiscal 2004.

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

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

PALO ALTO PUBLIC IMPROVEMENT CORPORATION  
A COMPONENT UNIT OF THE CITY OF PALO ALTO  
BALANCE SHEET  
JUNE 30, 2004

	Debt Service	Capital Projects	Totals
<b>ASSETS</b>			
Cash and investments held by trustee (Note 3)	\$1,412,860	\$1,039,340	\$2,452,200
Interest receivable	10,909	454	11,363
Investment in leases to City of Palo Alto (Note 2E)	<u>7,427,521</u>		<u>7,427,521</u>
Total Assets	<u>\$8,851,290</u>	<u>\$1,039,794</u>	<u>\$9,891,084</u>
<b>LIABILITIES</b>			
Deferred revenue	<u>\$7,427,521</u>		<u>\$7,427,521</u>
Total Liabilities	<u>7,427,521</u>		<u>7,427,521</u>
<b>FUND BALANCES</b>			
Reserved for:			
Debt service	1,423,769		1,423,769
Capital projects		<u>\$1,039,794</u>	<u>1,039,794</u>
Total Fund Balances	<u>1,423,769</u>	<u>1,039,794</u>	<u>2,463,563</u>
Total Liabilities and Fund Balances	<u>\$8,851,290</u>	<u>\$1,039,794</u>	
Accrual adjustment to remove deferred revenue from the balance sheet			
Deferred revenue			7,427,521
Construction in Progress used in governmental activities is not a financial resource and therefore not reported in funds			2,534,498
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			(199,219)
Due within one year			(720,000)
Due in more than one year			<u>(11,495,000)</u>
NET ASSETS OF GOVERNMENTAL ACTIVITIES			<u>\$11,363</u>

See accompanying notes to financial statements

PALO ALTO PUBLIC IMPROVEMENT CORPORATION  
A COMPONENT UNIT OF THE CITY OF PALO ALTO  
STATEMENT OF REVENUES, EXPENDITURES  
AND CHANGES IN FUND BALANCES  
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

	<u>Debt Service</u>	<u>Capital Projects</u>	<u>Totals</u>
<b>REVENUES</b>			
Lease receipts from City of Palo Alto:			
Principal	\$690,000		\$690,000
Interest	334,282		334,282
Interest from cash and investments	44,439	\$7,103	51,542
	<u>1,068,721</u>	<u>7,103</u>	<u>1,075,824</u>
<b>EXPENDITURES</b>			
Debt service:			
Principal repayment	690,000		690,000
Interest and fiscal agent charges	603,056		603,056
Capital projects		1,135,373	1,135,373
	<u>1,293,056</u>	<u>1,135,373</u>	<u>2,428,429</u>
<b>EXCESS OF REVENUES OVER (UNDER)</b>			
<b>EXPENDITURES</b>	(224,335)	(1,128,270)	(1,352,605)
Fund balances at beginning of year	<u>1,648,104</u>	<u>2,168,064</u>	<u>3,816,168</u>
Fund balances at end of year	<u><u>\$1,423,769</u></u>	<u><u>\$1,039,794</u></u>	<u><u>\$2,463,563</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, 2004

Net change in fund balances-total governmental funds	(\$1,352,605)
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Amounts reported for governmental activities in the statement of activities  
are different because:

Bond proceeds provide current financial resources to governmental funds, but  
issuing debt increases long-term liabilities in the Statement of Net Assets.  
Repayment of bond principal is an expenditure in the governmental funds, but  
in the Statement of Net Assets the repayment reduces long-term liabilities.

Fund balance is increased by the amount of debt repayment	690,000
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Capital outlay and capitalized interest costs are treated as an expenditures in governmental funds, but recorded as Construction in Progress on the Statement of Net Assets	1,376,914
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Some amounts reported in the Statement of Revenues, Expenditures and Changes in Fund Balances  
reflect the collection of an asset which are not includable as revenues on the Statement of Activities

Change in Investment in leases	(690,000)
Change in Interest payable	<u>3,600</u>

Change in net assets of governmental activities	<u><u>\$27,909</u></u>
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See accompanying notes to financial statements



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

**NOTE 1 - DESCRIPTION OF REPORTING ENTITY**

***General Description***

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

The Corporation is an integral part of the City of Palo Alto. It primarily services the City and its governing body is composed of the City Council. Therefore, the financial data of the Corporation has also been included as a blended component unit within the City's comprehensive annual financial report for the year ended June 30, 2004.

**NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES**

***A. Basis of Presentation***

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

***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.

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

<b>NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (Continued)</b>
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**B. Major Funds**

GASB Statement 34 defines major funds and requires that the Corporation's major governmental type funds be identified and presented separately in the Fund financial statements. Major funds are defined as funds that have either assets, liabilities, revenues or expenditures equal to ten percent of their fund-type total and five percent of the grand total. The Corporation has determined that all its funds are major funds.

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

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

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

**C. Non-exchange Transactions**

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

**D. Construction in Progress Net Financing Costs**

Interest incurred on debt used to finance projects are netted with interest earned on unspent proceeds of the debt. These "Net Financing Costs" are capitalized and added to construction in progress during the construction period to reflect the true project costs, including financing costs. During fiscal 2003-2004, net financing costs amounting \$69,908 were added to construction in progress.

**E. Investment in Leases**

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

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

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

**NOTE 3 - CASH AND INVESTMENTS HELD BY TRUSTEE**

At June 30, 2004 the Corporation's investments were recorded at market value and comprised the following:

*Category 1 Investments*

U.S. Agency Obligations	719,319
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*Pooled Investments (non Categorized):*

California Arbitrage Management Program	20,269
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Mutual funds	<u>1,712,612</u>
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Total cash and investments held by trustee	<u><u>\$2,452,200</u></u>
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The Trustee is only permitted to invest in US Corporation securities, US dollar denominated deposit accounts, federal funds, banker's acceptances, mutual funds, money market accounts, pre-funded municipal obligations, written repurchase agreement, and the California Arbitrage Management Program. Investments are purchased and held in the name of the Trustee on behalf of the Corporation and are held to maturity to match with payments required under the COP issue.

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

**NOTE 4 - CERTIFICATES OF PARTICIPATION**

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

	Balance June 30, 2003	Retirements	Balance June 30, 2004	Current Portion
<b>Governmental Activity Debt:</b>				
<b>Certificates of Participation</b>				
<b>1998 Golf Course</b>				
4.00-5.00%, due 09/01/2018	\$6,235,000	\$270,000	\$5,965,000	\$285,000
<b>2002A Civic Center Refinancing</b>				
2.00-4.00%, due 03/01/2012	3,200,000	315,000	2,885,000	325,000
<b>2002B Downtown Parking Improvements</b>				
4.55-6.00%, due 03/01/2022	3,470,000	105,000	3,365,000	110,000
	<u>\$12,905,000</u>	<u>\$690,000</u>	<u>\$12,215,000</u>	<u>\$720,000</u>

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

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

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

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

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

The COPs are payable and secured by lease revenues received by the Public Improvement Corporation from any City General Fund revenue source. Principal and interest are payable semi-annually each March 1 and September 1 beginning in 1999.

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

For the Year Ending June 30	Governmental Activities	
	Principal	Interest
2005	\$720,000	\$580,564
2006	740,000	555,687
2007	770,000	528,327
2008	805,000	497,310
2009	835,000	464,021
2010-2014	3,920,000	1,741,697
2015-2019	3,580,000	821,075
2020-2022	845,000	112,125
Total	<u>\$12,215,000</u>	<u>\$5,300,806</u>

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

**NOTE 5 - NET ASSETS AND FUND BALANCES**

The Bond documents require a Trustee to hold a portion of proceeds in a reserve fund for debt service purposes only. At June 30, 2004, the Trustee held \$1.399 million reserved, as discussed in Note 3.

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

**A. Net Assets**

Net Assets are divided into three captions under GASB Statement 34. These captions apply only to Net Assets as determined at the Government-wide level, and are described below:

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

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

**B. Fund Balances**

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

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

**FINANCIAL STATEMENTS**

**FOR THE YEAR ENDED  
JUNE 30, 2004**

CITY OF PALO ALTO REGIONAL WATER QUALITY CONTROL PLANT  
FINANCIAL STATEMENTS  
FOR THE YEAR ENDED JUNE 30, 2004

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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, 2004 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, 2004 on the basis of accounting described in Note 1.

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

*Maze & Associates*

October 19, 2004



CITY OF PALO ALTO  
REGIONAL WATER QUALITY CONTROL PLANT  
STATEMENT OF NET EXPENDITURES AND NET CHANGES IN COMMITMENTS  
FOR THE YEAR ENDED JUNE 30, 2004

	<u>Totals</u>	<u>City of Mountain View</u>	<u>City of Los Altos</u>	<u>City of Palo Alto</u>
<b>DIRECT EXPENDITURES:</b>				
Source control program	\$895,877	\$335,327	\$116,106	\$444,444
Public Outreach	54,204	20,289	7,025	26,890
Permitting and enforcement	752,703	329,136	20,186	403,381
Operations and maintenance	7,738,580	2,896,550	1,002,920	3,839,110
System improvement CIP (Note 2)	1,131,489	423,516	146,641	561,332
<b>Total Direct Expenditures</b>	<b>10,572,853</b>	<b>4,004,818</b>	<b>1,292,878</b>	<b>5,275,157</b>
<b>INDIRECT ADMINISTRATIVE EXPENDITURES:</b>				
Source control program	816,855	305,749	105,864	405,242
Public Outreach	2,535	948	329	1,258
Permitting and enforcement	556,585	154,888	9,499	392,198
Operations and maintenance	898,979	336,488	116,508	445,983
<b>Total Indirect Expenditures</b>	<b>2,274,954</b>	<b>798,073</b>	<b>232,200</b>	<b>1,244,681</b>
<b>DEBT SERVICE EXPENDITURES:</b>				
Refunding 1990 Series A Bonds	309,325	157,756	24,127	127,442
1999 Wastewater Treatment New Project	542,396	205,514	51,365	285,517
<b>Total Debt Service Expenditures</b>	<b>851,721</b>	<b>363,270</b>	<b>75,492</b>	<b>412,959</b>
<b>TOTAL EXPENDITURES</b>	<b>13,699,528</b>	<b>5,166,161</b>	<b>1,600,570</b>	<b>6,932,797</b>
<b>DEDUCT JOINT SYSTEMS REVENUES (Note 5)</b>	<b>(271,640)</b>	<b>(101,675)</b>	<b>(35,205)</b>	<b>(134,760)</b>
<b>NET EXPENDITURES</b>	<b>13,427,888</b>	<b>5,064,486</b>	<b>1,565,365</b>	<b>6,798,037</b>
<b>ADD NET CHANGES IN COMMITMENTS</b>	<b>989,753</b>	<b>370,465</b>	<b>128,272</b>	<b>491,016</b>
<b>NET EXPENDITURES AND NET CHANGES IN COMMITMENTS DUE FROM MEMBERS</b>	<b>\$14,417,641</b>	<b>\$5,434,951</b>	<b>\$1,693,637</b>	<b>\$7,289,053</b>

See notes to financial statements

CITY OF PALO ALTO  
REGIONAL WATER QUALITY CONTROL PLANT  
STATEMENT OF QUARTERLY BILLINGS  
FOR THE YEAR ENDED JUNE 30, 2004

	<u>City of Mountain View</u>	<u>City of Los Altos</u>
BILLINGS BY QUARTER BEGINNING:		
July 1, 2003	\$1,403,436	\$457,552
October 1, 2003	1,512,378	480,404
January 1, 2004	1,403,436	457,552
April 1, 2004	<u>1,657,249</u>	<u>510,046</u>
Total quarterly billings	5,976,499	1,905,554
Net expenditures and net changes in commitments	<u>5,434,951</u>	<u>1,693,637</u>
Excess of net expenditures and net changes in commitments over total billings	<u><u>\$541,548</u></u>	<u><u>\$211,917</u></u>

See notes to financial statements

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

**NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES**

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

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

Plant expenditures, commitments and joint system revenues, debt service and industrial waste compliance expenditures are shared by the Members based on agreed upon allocation percentages. The expenditures and commitments, including indirect administrative expenditures (see Note 3), are allocated to each of the Members based primarily on their respective percentages of the annual sewage flow and treatment needed for suspended solids, chemical oxygen demand and ammonia. Commitments represent operating encumbrances with suppliers for long-term projects which have not yet been completed. Net changes in commitments represent commitments of \$2,951,107 at June 30, 2004 less commitments of \$1,961,354 at June 30, 2003. 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"><b>CITY OF PALO ALTO REGIONAL WATER QUALITY CONTROL PLANT</b>  <b>NOTES TO FINANCIAL STATEMENTS</b></p>
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<p><b>NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES (Continued)</b></p>
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The percentages used for the year ended June 30, 2004 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	37.43%	12.96%	49.61%
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	36.97%	2.27%	60.76%

The City is allocated 49.61% 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 2003-2004 allocations are as follows:

East Palo Alto Sanitary District	7.55%
Stanford University	5.35%
Town of Los Altos Hills	0.94%
Remaining City percentage	35.77%
Total	<u>49.61%</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.

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

**NOTE 2 - SYSTEM IMPROVEMENT CIP (MINOR CAPITAL)**

The basic agreement between the Members, dated October 10, 1968, provides that the administrator of the Plant is responsible for capital additions. These capital additions should be for the replacement of obsolete or worn-out units, or minor capital additions to improve the efficiency of the Plant's operation. Per an addendum to the agreement dated March 16, 1998, the Members agreed that capital additions could not exceed \$1.9 million in 1998-99 (base year). For future years, the base year amount will be adjusted annually based on increases to the Consumer Price Index-Urban Wage Earners and Clerical Workers for the San Francisco-Oakland-San Jose area. Actual System Improvement CIP expenditures amounted to \$1,131,489 for 2003-2004.

**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, 2004, 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 \$10,027,902.

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

<p><b>NOTE 4 – DEBT SERVICE EXPENDITURES (Continued)</b></p>
--

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	\$2,509,019	\$863,225	\$3,372,244
City of Mountain View	2,491,268	1,760,981	4,252,249
City of Los Altos	622,653	269,326	891,979
Town of Los Altos Hills	103,885	6,906	110,791
East Palo Alto Sanitary District	502,330	410,895	913,225
Stanford University	345,845	141,569	487,414
Total	<u>\$6,575,000</u>	<u>\$3,452,902</u>	<u>\$10,027,902</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.

<p><b>NOTE 5 – JOINT SYSTEM REVENUES</b></p>
--

The plant's joint system revenues for the year ended June 30, 2004, totaled \$271,640. This consisted of \$15,000 for salt water marsh services, \$44,240 from the City's Water Fund for lab services, \$90,556 for septic tank hauling services and \$121,844 for other revenues.

<p><b>NOTE 6 - RELATED PARTY TRANSACTIONS</b></p>
---

During fiscal 2004, the Plant paid the City \$1,769,338 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 \$43,148 were paid to the City of Palo Alto Equipment Replacement Fund. Of the total \$30,846, \$6,740 and \$5,562 are included in the statement of net expenditures and net changes in commitments as operations and maintenance expenditures, source control program and permitting and enforcement respectively.

**CABLE TV FRANCHISE**  
**STATEMENTS OF FRANCHISE**  
**REVENUES AND EXPENDITURES**  
**FOR THE YEARS ENDED**  
**DECEMBER 31, 2003 AND 2002**

<p style="text-align: center;"><b>CABLE TV FRANCHISE STATEMENT OF FRANCHISE REVENUES AND EXPENDITURES FOR THE YEARS ENDED DECEMBER 31, 2003 AND 2002</b></p>
--

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## INDEPENDENT AUDITOR'S REPORT

The Members of the  
Cable TV Franchise

We have audited the accompanying Statements of Franchise Revenues and Expenditures of the Cable TV Franchise (Franchise) for the years ended December 31, 2003 and 2002 as listed in the table of contents. This financial statement is the responsibility of the City's management. Our responsibility is to express an opinion on this financial statement based on our audits.

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

As discussed in Note 1 to the financial statement, the statements referred to above were prepared for the purpose of complying with the provisions of the Joint Operating Agreement signed on October 13, 1988 between the City of Palo Alto, the City of East Palo Alto, the City of Menlo Park, the County of San Mateo, the County of Santa Clara and the Town of Atherton, for the provision of cable television services, and are not intended to be a presentation in accordance with generally accepted accounting principles in the United States of America.

In our opinion, the statements referred to above present fairly in all material respects the revenues and expenditures of the Franchise for the years ended December 31, 2003 and 2002 on the basis of accounting described in Note 1.

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

*Maze & Associates*

April 1, 2004

CABLE TV FRANCHISE  
STATEMENTS OF FRANCHISE REVENUES AND EXPENDITURES  
YEARS ENDED DECEMBER 31, 2003 AND 2002

	<u>2003</u>	<u>2002</u>
REVENUES:		
Franchise fees	<u>\$824,133</u>	<u>\$802,489</u>
Total Receipts	<u>824,133</u>	<u>802,489</u>
EXPENDITURES:		
Franchise administration	62,171	108,568
Consulting fees	<u>46,382</u>	<u>22,803</u>
Total Expenditures	<u>108,553</u>	<u>131,371</u>
Net Receipts	<u><u>\$715,580</u></u>	<u><u>\$671,118</u></u>

DISTRIBUTED NET RECEIPTS:

	<u>2003</u>		<u>2002</u>	
	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Allocation of Net Receipts:				
City of Palo Alto	\$357,278	50%	\$336,882	50%
City of Menlo Park	189,718	26%	179,154	27%
City of East Palo Alto	82,884	12%	72,098	11%
Town of Atherton	47,333	7%	46,132	7%
County of Santa Clara	22,583	3%	21,894	3%
County of San Mateo	<u>15,784</u>	<u>2%</u>	<u>14,958</u>	<u>2%</u>
Total	<u><u>\$715,580</u></u>	<u><u>100%</u></u>	<u><u>\$671,118</u></u>	<u><u>100%</u></u>

See accompanying notes to financial statements

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

**NOTE 1 - JOINT OPERATING AGREEMENT AND BASIS OF ACCOUNTING**

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

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

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

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

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

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

**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  
REVENUE AND EXPENDITURES  
Notes to Financial Statement**

**NOTE 2 - PRIOR FRANCHISE SETTLEMENTS (Continued)**

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

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

These amounts have been deposited and are being held in the City and are earning interest. As of December 31, 2003, the total amount on deposit amounted to \$768,599.

**NOTE 3 - COMMITMENT AND CONTINGENCIES**

The City, on behalf of the Cable Joint Powers agreement member, has pursued a franchise violation against Comcast for failure to complete certain rebuild requirements as specified in the franchise agreement. Settlement of this violation is not expected to impact franchise revenues included in this report.

**CITY OF PALO ALTO**  
**BICYCLE/PEDESTRIAN PROJECTS**  
**FINANCIAL STATEMENTS**  
**FOR THE YEARS ENDED**  
**JUNE 30, 2004 AND 2003**

**CITY OF PALO ALTO**  
**Bicycle/Pedestrian Projects**  
**Financial Statements**  
**For the Years Ended June 30, 2004 and 2003**

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## INDEPENDENT AUDITOR'S REPORT

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

We have audited the financial statements of the City of Palo Alto Bicycle/Pedestrian Projects (Projects) of the City of Palo Alto, as of and for the years ended June 30, 2004 and 2003, as listed in the table of contents. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on the financial statements based on our audits.

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the City of Palo Alto Bicycle/Pedestrian Projects at June 30, 2004 and 2003, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles in the United States of America.

*Maze Associates*

October 19, 2004

CITY OF PALO ALTO  
BICYCLE/PEDESTRIAN PROJECTS  
BALANCE SHEETS  
JUNE 30, 2004 AND 2003

	<u>2004</u>	<u>2003</u>
ASSETS		
Cash		
Accounts receivable	<u>\$493,000</u>	<u>\$190,037</u>
Total Assets	<u><u>\$493,000</u></u>	<u><u>\$190,037</u></u>
LIABILITIES		
Due to the City	<u>\$493,000</u>	<u>\$190,037</u>
Total Liabilities	<u><u>\$493,000</u></u>	<u><u>\$190,037</u></u>

See accompanying note to financial statements



CITY OF PALO ALTO  
BICYCLE/PEDESTRIAN PROJECTS  
STATEMENTS OF REVENUES AND EXPENDITURES  
FOR THE YEARS ENDED JUNE 30, 2004 AND 2003

	<u>2004</u>	<u>2003</u>
<b>REVENUE</b>		
TDA Article 3.0 (Note 2)	<u>\$517,124</u>	<u>\$190,037</u>
<b>TOTAL</b>	<u><u>\$517,124</u></u>	<u><u>\$190,037</u></u>
<b>EXPENDITURES</b>		
San Mateo Drive Bike Bridge	\$16,657	\$6,567
Design and Engineering for Arastradero Bike Lanes Project		80,324
Embarcadero Bike Bridge		95,510
Bicycle Safety Education Program		5,000
Bikeway System Improvement	7,467	2,636
Homer Avenue Undercrossing	<u>493,000</u>	
<b>TOTAL</b>	<u><u>\$517,124</u></u>	<u><u>\$190,037</u></u>

See accompanying notes to financial statements

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

**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

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

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

**A. Fund Accounting**

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

**B. Basis of Accounting**

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

**NOTE 2 - TDA ARTICLE 3.0 REVENUE**

During the year ended June 30, 2004 the City received allocation instructions from the Metropolitan Transportation Commission for the following projects:

Instruction #	Project Name	Grant Award	Revenue at June 30, 2004
02336623	Sidewalk Improvement	\$50,000	
02336624	Bicycle Safety Education Program	5,000	
02336625	Bicycle Parking Facilities	5,209	
03345210	Homer Avenue Undercrossing	200,000	\$200,000
04355008	Homer Avenue Undercrossing	293,000	293,000
03345211	San Mateo Drive Bike Bridge	16,567	16,567
04355009	California Avenue and US 101 Bike Project	15,993	7,467
04355010	Pedestrian Walkway Warning System	20,000	
			<u>\$517,034</u>

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**INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE  
WITH RULES AND REGULATIONS OF THE TRANSPORTATION  
DEVELOPMENT ACT**

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

We have audited the financial statements of the City of Palo Alto Bicycle/Pedestrian Projects (Projects) as of and for the years ended June 30, 2004 and 2004. Our audit was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and other such auditing procedures as we considered necessary in the circumstances. This report is given in compliance with Public Utilities Code 99245 contained in the Transportation Development Act as enacted and amended by statute in January 1987.

In conjunction with our audit, we performed tests of compliance with the applicable provisions of the Transportation Development Act and the allocation instructions and resolutions and the rules and regulations of the Metropolitan Transportation Commission as required by Title 21 of the California Code of Regulations section 6666.

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

*Maze & Associates*

October 19, 2004

**REDEVELOPMENT AGENCY OF  
THE CITY OF PALO ALTO  
COMPONENT UNIT FINANCIAL STATEMENTS  
FOR THE YEAR ENDED  
JUNE 30, 2004**

**REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO  
COMPONENT UNIT FINANCIAL STATEMENTS  
FOR THE YEAR ENDED JUNE 30, 2004**

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## INDEPENDENT AUDITOR'S REPORT ON THE FINANCIAL STATEMENTS

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

We have audited the accompanying component unit financial statements of the governmental activities and major fund of the Redevelopment Agency of the City of Palo Alto, a component unit of the City of Palo Alto, as of and for the year ended June 30, 2004, as listed in the Table of Contents. These component unit financial statements are the responsibility of the Agency's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In accordance with Government Auditing Standards, we have also issued reports dated October 19, 2004 on our consideration of the Agency's internal control structure and on its compliance with laws and regulations.

In our opinion the component unit financial statements referred to above present fairly in all material respects the financial position of the governmental activities and major fund of the Redevelopment Agency of the City of Palo Alto for the year ended June 30, 2004 and the changes in financial position for the year then ended, in conformity with generally accepted accounting principles in the United States of America.

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

*Maze & Associates*

October 19, 2004

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

Last year, the Redevelopment Agency (Agency) of the City of Palo Alto, a component unit of the City of Palo Alto, implemented the provisions of Government Accounting Standards Board Statement 34, "Basic Financial Statements and Management's Discussion & Analysis for State and Local Governments", known as GASB 34 represents a profound and far-reaching change in accounting and reporting for municipalities; it is an effort to make these statements clearer and more understandable to readers.

The Agency is controlled by the City of Palo Alto and was formed on October 9, 2001.

### **FISCAL 2004 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 2004, the Agency incurred on-going costs in the amount of \$9 thousand, a decrease of \$92 thousand from prior year. The Agency received a transfer from the City of Palo Alto in the amount \$9 thousand to fund these costs, a decrease of \$95 thousand from prior year. The prior year transfer covered on-going cost of \$101 thousand and a net asset deficit in the amount of \$3 thousand. As of June 30, 2004, the Agency had not yet adopted a project area nor received any tax increment revenues.

### **OVERVIEW OF THE AGENCY'S BASIC FINANCIAL STATEMENTS**

The Basic Financial statements are in two parts:

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

#### **The Basic Financial Statements**

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

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

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

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

## **ECONOMIC OUTLOOK AND MAJOR INITIATIVES**

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

## **CONTACTING THE AGENCY'S FINANCIAL MANAGEMENT**

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



THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO  
A COMPONENT UNIT OF THE CITY OF PALO ALTO  
STATEMENT OF NET ASSETS  
JUNE 30, 2004

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, 2004

EXPENSES

Planning and Community  
reimbursements to the City

(\$8,500)

Change in Net Assets

(8,500)

GENERAL REVENUES

Transfers from the City of Palo Alto

8,500

Net assets (deficit) at the beginning of year

Net assets at the end of year

See accompanying notes to financial statements

<b>REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO</b>
--

<b>FUND FINANCIAL STATEMENTS</b>
----------------------------------

The Redevelopment Agency (Agency) of the City of Palo Alto only has one fund in fiscal 2004, as follows:

**REDEVELOPMENT AGENCY GENERAL FUND**

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

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO  
A COMPONENT UNIT OF THE CITY OF PALO ALTO  
BALANCE SHEET  
JUNE 30, 2004

	<u>General Fund</u>
<b>LIABILITIES</b>	
Due to the City of Palo Alto	<u>                    </u>
<b>FUND BALANCES</b>	
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**  
**STATEMENTS OF REVENUES, EXPENDITURES**  
**AND CHANGES IN FUND BALANCE**  
**FOR THE YEAR ENDED JUNE 30, 2004**

	<u>General Fund</u>
<b>OTHER FINANCING USES</b>	
Transfers in from the City of Palo Alto (Note 2)	\$8,500
Transfers (out) to the City of Palo Alto (Note 2)	<u>(8,500)</u>
Fund (deficit) at beginning of year	<u>                    </u>
Fund at end of year	<u><u>                    </u></u>

See accompanying notes to financial statements

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO  
A COMPONENT UNIT OF THE CITY OF PALO ALTO  
STATEMENTS OF REVENUES, EXPENDITURES  
AND CHANGES IN FUND BALANCES - BUDGET AND ACTUAL  
GENERAL FUND  
FOR THE YEAR ENDED JUNE 30, 2004

	<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)				
Transfers in from the City of Palo Alto		\$8,500	\$8,500	
Transfers out to the City of Palo Alto	<u>(\$8,500)</u>	<u>(8,500)</u>	<u>(8,500)</u>	
Total Other Financing Sources (Uses)				
EXCESS (DEFICIENCY) OF REVENUES AND				
OTHER FINANCING SOURCES OVER				
EXPENDITURES AND OTHER USES	<u>(\$8,500)</u>			
Fund (deficit) at beginning of year				
Fund at end of year				

See accompanying notes to financial statements

**THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO**  
**Notes to Component Unit Financial Statements**  
**For the Year Ended June 30, 2004**

**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNT POLICIES**

**A. *Organization and Purpose***

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

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

**B. *Basis of Presentation***

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

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

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

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

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

**C. *Major Funds***

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

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

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

**THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO**  
**Notes to Component Unit Financial Statements**  
**For the Year Ended June 30, 2004**

**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNT POLICIES (Continued)**

**REDEVELOPMENT AGENCY GENERAL FUND**

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

**D. Basis of Accounting**

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

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

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

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

**E. Budgets and Budgetary Accounting**

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

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

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

**F. Net Assets**

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

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



**THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO**  
**Notes to Component Unit Financial Statements**  
**For the Year Ended June 30, 2004**

**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNT POLICIES (Continued)**

**G. *Fund Balances, Reserves and Designations***

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

**NOTE 2 – TRANSACTIONS WITH THE CITY**

During fiscal year 2001-02, the City established the Palo Alto Redevelopment Agency. The Agency and the City have an agreement whereby the City will advance funds to the Agency in support of start up and formation costs. However, the interfund advances have no specific repayment date. Generally accepted accounting principles require that such amounts be treated as transfers in the year made. As of June 30, 2004, the Agency owed the City \$338 thousand in advances without specified repayment terms.

Agency activities are performed by City staff. During fiscal year 2003-2004, the City charged the Agency \$8,500 for costs incurred on Agency activities. This amount was transferred to the City's General Fund as reimbursement.

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

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

We have audited the financial statements of the Redevelopment Agency (Agency) of the City of Palo Alto for the year ended June 30, 2004, and have issued our report thereon dated October 19, 2004. We have conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

***Compliance***

As part of obtaining reasonable assurance about whether the Agency's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. Those provisions include provisions of laws and regulations identified in the *Guidelines for Compliance Audits of California Redevelopment Agencies*, issued by the State Controller. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance.

***Internal Control Over Financial Reporting***

In planning and performing our audit, we considered the Agency's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. We noted other matters involving internal control over financial reporting that we have reported to management of the Agency in a separate letter dated October 19, 2004.

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

*Maze + Associates*

October 19, 2004

A Professional Corporation