



## CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

June 10, 2019

The Honorable City Council  
Palo Alto, California

### **Finance Committee Recommends the City Council Accept the Macias Gini & O'Connell's Audit of the City of Palo Alto's Financial Statements as of June 30, 2018 and Management Letter**

The Office of the City Auditor recommends acceptance of the City of Palo Alto's audited financial statements for the fiscal year ended June 30, 2018, and the accompanying reports provided by Macias Gini & O'Connell LLP (MGO). At its meeting on December 4, 2018, the Finance Committee approved and unanimously recommended that the City Council accept the City of Palo Alto's audited financial statements and accompanying reports. [The City Auditor's report to the Finance Committee](#) and the [transcript minutes](#) are available on the City's [Finance Committee website](#).

Respectfully submitted,

Don Rhoads, CPA  
Special Advisor to the Office of the City Auditor  
Management Partners

#### **ATTACHMENTS:**

- Attachment A: Report to the City Council (PDF)
- Attachment B: Cable TV Franchise (PDF)
- Attachment C: Public Improvement Corporation(PDF)
- Attachment D: Regional Water Quality Control Plant (PDF)
- Attachment E: Agreed-Upon Procedures Related to the Article XIII-B Appropriation Limit (PDF)

Department Head: Don Rhoads, Special Advisor to the Office of the City Auditor



**CITY OF PALO ALTO**

Report to the City Council

For the Year Ended June 30, 2018



Certified  
Public  
Accountants

**CITY OF PALO ALTO**  
**Report to the City Council**  
**For the Year Ended June 30, 2018**

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

We have audited the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of Palo Alto, California (City), as for the year ended June 30, 2018. Professional standards require that we provide you with information about our responsibilities under generally accepted auditing standards, *Government Auditing Standards* and the Uniform Guidance, as well as certain information related to the planned scope and timing of our audit. We have communicated such information in our letter to you dated March 19, 2018. Professional standards also require that we communicate to you the information on pages 1 through 4 related to our audit.

In planning and performing our audit of the City's financial statements as of and for the year ended June 30, 2018, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of City's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as discussed below, we identified a certain deficiency in internal control that we consider to be a significant deficiency.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiency in internal control to be a significant deficiency, as described in item 2018-001 in the accompanying Current Year Recommendations. In addition, we identified a deficiency in internal control as described in the accompanying Current Year Recommendations as item 2018-002.

This communication is intended solely for the information and use of the Mayor and City Council, the Finance Committee, management and others within the City, and is not intended to be and should not be used by anyone other than these specified parties.

*Macias Gini & O'Connell LLP*

Walnut Creek, California  
November 19, 2018

**CITY OF PALO ALTO**  
**Report to the City Council**  
**For the Year Ended June 30, 2018**

## **REQUIRED COMMUNICATIONS**

We have audited the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City for the fiscal year ended June 30, 2018. Professional standards require that we communicate to you the following information:

### Significant Audit Matters

#### ***Qualitative Aspects of Accounting Practices***

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the City are described in Note 1. As described in Note 1(n) to the City's basic financial statements, the City implemented four new Governmental Accounting Standards Board (GASB) pronouncements, consisting of:

- Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*;
- Statement No. 81, *Irrevocable Split-Interest Agreements*;
- Statement No. 85, *Omnibus 2017*; and
- Statement No. 86, *Certain Debt Extinguishments Issues*.

For the implementation of GASB Statement No. 75, as of July 1, 2017, the City restated its net position to record the beginning net other postemployment benefits (OPEB) liability, record deferred outflows of resources related to OPEB contributions made after the beginning measurement date, and write-off the net OPEB asset recorded in accordance with GASB Statement No. 45. Implementation of the other statements did not have a significant impact on the City for the fiscal year ended June 30, 2018.

We noted no transactions entered into by the City during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected.

The most sensitive estimates affecting the financial statements were:

- *Fair value of investments.* The City's investments are generally carried at fair value, which is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The City's investments are primarily classified as level 2 of the fair value hierarchy established by GASB Statement No. 72 and are valued using prices determined by the use of matrix pricing techniques maintained by the pricing vendors for these securities. The City's investment in the money market mutual funds, California Local Agency Investment Fund and California Asset Management Program are not subject to the fair value hierarchy.

**CITY OF PALO ALTO**  
**Report to the City Council**  
**For the Year Ended June 30, 2018**

- *Estimated allowance for losses on notes and loans receivable.* The allowance for losses on notes and loans receivable was based on management's estimate regarding the likelihood of collectability.
- *Useful life estimates for capital assets.* The estimated useful lives of capital assets were based on management's estimate of the economic life of its capital assets.
- *Landfill post-closure Liability.* The City has estimated, based on a study conducted by consultants, the post-closure costs of the Palo Alto landfill based on what it would cost to perform all currently mandated post-closure care. Actual post-closure care costs may be higher due to inflation variances, changes in technology, or changes in State or federal regulations.
- *Valuation and disclosure of net pension liability, pension expense and pension related deferred outflows and inflows of resources.* The amounts reported are based on actuarial valuations performed by California Public Employees Retirement System.
- *Valuation and disclosure of net OPEB liability, OPEB expense and OPEB related deferred outflows and inflows of resources.* The amounts reported are based on actuarial valuations performed by the City's independent actuaries.
- *Annual required contributions to pension and other postemployment benefit plans.* The City is required to contribute to its pension and OPEB plans at an actuarially determined rate and to measure these benefit costs based upon certain approved actuarial assumptions.
- *Claims loss reserve.* The City is exposed to a variety of risks of loss due to general liability, workers' compensation and other claims and records an estimate of these losses based on actuarial studies performed by third party actuaries. These studies are prepared based on the City's prior claims history, which is used as a basis for extrapolating losses for known and incurred but not reported claims. Actual loss experience may vary from these estimates.

We evaluated the key factors and assumptions used to develop the accounting estimates described above in determining that they are reasonable in relation to the City's basic financial statements taken as a whole.

Certain financial statements disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosures affecting the financial statements were the disclosure of the City's Pension Plans in Note 11, the Other Post-Employment Benefits (OPEB) in Note 12 and the Commitments and Contingencies in Note 16.

The financial statement disclosures are neutral, consistent, and clear.

***Difficulties Encountered in Performing the Audit***

We encountered no difficulties in dealing with management in performing and completing our audit.

***Corrected and Uncorrected Misstatements***

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. No uncorrected misstatements were detected as a result of audit procedures. The following material misstatement was detected as a result of our audit procedures and was corrected by management: accounting treatment of the 2017 State Water Resources Loan. See related current year recommendation 2018-001.



**CITY OF PALO ALTO**  
**Report to the City Council**  
**For the Year Ended June 30, 2018**

***Disagreements with Management***

For purposes of this letter, a disagreement with management is a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

***Management Representations***

We have requested certain representations from management that are included in the management representation letter dated November 19, 2018.

***Management Consultations with Other Independent Accountants***

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the City's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

***Other Audit Findings or Issues***

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the City's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

**Other Matters**

We applied certain limited procedures to the management's discussion and analysis, the schedules of changes in net pension liability and related ratios, the schedule of employer pension contributions, the schedule of changes in net OPEB liability and related ratios, the schedule of employer OPEB contributions, which are required supplementary information (RSI) that supplements the basic financial statements. Our procedures consisted of inquiries of management regarding the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We did not audit the RSI and do not express an opinion or provide any assurance on the RSI.

We were engaged to report on the combining and individual nonmajor fund financial statements and schedules and the schedule of expenditures of federal awards, as required by Title 2 U.S. Code of Federal Regulations Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*, which accompany the financial statements but are not RSI. With respect to this supplementary information, we made certain inquiries of management and evaluated the form, content, and methods of preparing the information to determine that the information complies with accounting principles generally accepted in the United States of America, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We compared and reconciled the supplementary information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves.

**CITY OF PALO ALTO**  
**Report to the City Council**  
**For the Year Ended June 30, 2018**

We were not engaged to report on the introductory and statistical sections, which accompany the financial statements but are not RSI. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

**CITY OF PALO ALTO**  
**Report to the City Council**  
**For the Year Ended June 30, 2018**

**CURRENT YEAR RECOMMENDATIONS**

**Item 2018-001                      Significant Deficiency**  
**Internal Controls over Financial Reporting**

Effective March 20, 2017, the City and the State Water Resources Control Board (SWRCB) entered into an agreement to award the City up to \$30 million from its Clean Water State Revolving Fund for the Sludge Dewatering and Loadout Facility project. The SWRCB loan is to be repaid over 30 years at a rate of 1.8%, with the first annual installment due on May 31, 2020. In September 2017, due to the projected lower project costs, the agreement was amended to reduce the SWRCB loan amount to \$29.7 million. Under the terms of the agreement, \$4 million of the SWRCB loan is a federal pass through grant from the U.S. Environmental Protection Agency under its Capitalization Grants for Clean Water State Revolving Funds program.

On August 4, 2018, the City received a letter from the SWRCB explaining the status of the SWRCB loan and the federal pass through grant. The letter clarified the funding sources and summarized the project draws through the date of the letter. Based on the information provided in the SWRCB letter, we observed the following two issues:

1. The SWRCB letter on August 4, 2018 clarified that the project costs included in the first two draws submitted to SWRCB were applied to the federal awards first, before applying them to State funding sources. Therefore, an adjustment of \$4,000,000 was necessary to reduce the SWRCB loan balance and recognize grant revenue for the year ended June 30, 2018.
2. The City incurred eligible project costs of \$4,964,775 during the year ended June 30, 2018 and submitted the loan draws subsequent to year end. Accordingly, the City accrued draws made in July and August as a receivable from the SWRCB and as an obligation for SWRCB loan payable. The draws for the \$4,964,775 were not made by June 30, 2018, therefore City does not owe that amount to SWRCB as of year-end and overstated its obligation for the SWRCB loan. An audit adjustment of \$4,964,775 was necessary to reduce the SWRCB loan balance at June 30, 2018 and reduce receivables from the SWRCB to properly account for the loan.

We recommend the City document the important terms and conditions of the SWRCB loan, to ensure proper internal controls over the financial reporting and compliance. The City's Finance department should also collaborate with other departments that have material or complex transactions to strengthen internal controls over financial reporting and compliance.

**Management Response**

The City concurs with the finding and recommendation. City staff will update the year-end closing processes and procedures to ensure that all material transactions and balances are properly reflected in the financial statements in conformance with Generally Accepted Accounting Principles (GAAP) and the terms and conditions of the loan.

**CITY OF PALO ALTO  
Report to the City Council  
For the Year Ended June 30, 2018**

**Item 2018-002****Control Deficiency****Internal Controls over Purchasing Card Disbursements**

During our audit, we selected a sample of 25 purchasing card (P-Card) cardholder monthly statements to test the operating effectiveness of the internal controls over the P-Card disbursement process, including a review of the transactions on the monthly statements for compliance with internal policies. We observed three exceptions with the City's P-Card Guidebook, whereby cardholders exceeded the standard monthly spending limit of \$15,000. While the City staff routinely approve individual spending limit increases, the City was unable to locate email authorizations for these increases.

We recommend the City perform a regular review of its P-Card Guidebook to consider whether updates are necessary to address the City's evolving operational needs. The City staff should adhere to processes in the P-Card Guidebook to ensure that the City's P-Card disbursements are for appropriate purposes and within each employee's authorized limit. We recommend that City staff maintain accurate and updated documentation of the approval process and review P-Card reporting tools to ensure that spending limits are correct and proper authorization is documented.

**Management Response**

The City concurs with the finding and recommendation and will review the P-Card Guidebook to ensure that authorization is documented for cardholders requiring a higher limit due to operational need. City staff review reporting tools in the P-Card online system to perform a regular review of monthly spend limits and consider other areas within the P-Card process where internal control can be improved.

**STATUS OF PRIOR YEAR RECOMMEDATION**

None reported.

**CABLE TV FRANCHISE**  
Independent Auditor's Report  
and Statements of Franchise  
Revenues and Expenses

For the Years Ended  
December 31, 2017 and 2016



Certified  
Public  
Accountants

**CABLE TV FRANCHISE**  
For the Years Ended December 31, 2017 and 2016

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## **Independent Auditor's Report**

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

We have audited the accompanying Statements of Franchise Revenues and Expenses of the Cable TV Franchise (Franchise) for the years ended December 31, 2017 and 2016, and the related notes to the financial statements, which collectively comprise the Franchise's financial statements as listed in the table of contents.

### ***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the financial reporting provisions of the Amended and Restated Joint Exercise of Powers Agreement signed on June 9, 2009, 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 as described in Note 1 to the financial statements. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### ***Auditor's Responsibility***

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### ***Opinion***

In our opinion, the financial statements referred to above present fairly, in all material respects, the revenues and expenses of the Franchise for the years ended December 31, 2017 and 2016, in accordance with the financial reporting provisions of the Amended and Restated Joint Exercise of Powers Agreement signed on June 9, 2009, 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 as described in Note 1 to the financial statements.

***Basis of Accounting***

As discussed in Note 1 to the financial statements, the financial statements are prepared in accordance with the financial reporting provisions of the Amended and Restated Joint Exercise of Powers Agreement signed on June 9, 2009, 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, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

***Restriction on Use***

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

A handwritten signature in dark ink that reads "Macias Gini & O'Connell LLP". The signature is written in a cursive, flowing style.

Walnut Creek, California  
November 19, 2018



**CABLE TV FRANCHISE**  
 Statements of Franchise Revenues and Expenses  
 For the Years Ended December 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>
<b>Revenues:</b>		
Franchise fees	<u>\$ 1,878,392</u>	<u>\$ 1,908,848</u>
<b>Expenses:</b>		
Franchise administration	44,293	40,258
Consulting fees	<u>12,609</u>	<u>4,650</u>
Total expenses	<u>56,902</u>	<u>44,908</u>
<b>Net revenues</b>	<u><u>\$ 1,821,490</u></u>	<u><u>\$ 1,863,940</u></u>

	<u>2017</u>		<u>2016</u>	
	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
<b>Allocation of Net Revenues:</b>				
City of Palo Alto	\$ 890,738	48.9%	\$ 917,010	49.2%
City of Menlo Park	486,334	26.7%	498,894	26.8%
City of East Palo Alto	179,809	9.9%	186,524	10.0%
Town of Atherton	141,690	7.8%	141,691	7.6%
County of Santa Clara	97,564	5.4%	94,847	5.1%
County of San Mateo	<u>25,355</u>	<u>1.4%</u>	<u>24,974</u>	<u>1.3%</u>
Total allocated net revenues	<u><u>\$ 1,821,490</u></u>	<u><u>100.0%</u></u>	<u><u>\$ 1,863,940</u></u>	<u><u>100.0%</u></u>

See accompanying notes to the financial statements.

**CABLE TV FRANCHISE**  
Notes to the Financial Statements  
For the Years Ended December 31, 2017 and 2016

**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 (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 of Palo Alto (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 (AT&T), a third party contractor, which was granted a non-exclusive franchise to construct, operate, maintain and repair a cable television system within the Members jurisdictions. In 2002, the Franchise Agreement was transferred from AT&T to Comcast Corporation (Comcast).

TCI Cablevision of California, Inc. 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, the Members entered into a Joint Operating Agreement in which 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 Agreement. The activities are administered by the City and are accounted for within the City's Agency Fund. The program is accounted for using the accrual basis of accounting. Under the accrual basis of accounting, revenues are recorded when earned and expenses are recognized when the liability is incurred.

On January 1, 2007, the Digital Infrastructure and Video Competition Act (DIVCA) went into effect. Under DIVCA, cable and video service franchises are now granted exclusively by the California Public Utilities Commission (Commission) rather than by local franchising entities. On March 30, 2007, the Commission granted AT&T a statewide franchise. Comcast was allowed to seek a state franchise after January 1, 2008, when another state franchise holder (in this case AT&T) entered the local market. On January 2, 2008, the Commission granted Comcast a state franchise.

On June 9, 2009, the Members approved an amended and restated Joint Exercise of Powers Agreement, in substitution of the existing Joint Exercise of Powers Agreement and the Joint Operating Agreement, to reflect changes in the law due to DIVCA and to continue to allow the City to administer the cable and video franchise enforcement and monitoring process for state franchise holders.

The accompanying financial statements are intended to present the Franchise's revenues and expenses pursuant to the Joint Exercise of Powers Agreement and are not intended to be a complete presentation of the Franchise's financial position or results of operations.

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

**CABLE TV FRANCHISE**  
Notes to the Financial Statements  
For the Years Ended December 31, 2017 and 2016

**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 hired a cable communications consultant and retained the services of a law firm to assist in the franchise renewal process. On July 31, 2000, CCCOPA reimbursed the City \$185,000 toward the actual costs incurred as part of the franchise renewal efforts.

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

On November 22, 2004, the City reached a settlement agreement with Comcast regarding cable plant construction claims in the amount of \$175,000. This money was to be used towards the institutional network connection costs.

In 2006, the City conducted a franchise compliance audit performed by the City Auditor's Office. A settlement was reached in the amount of \$155,391. In addition, CCCOPA paid the City a \$250,000 grant to acquire, install, and/or maintain equipment to be used in connection with an institutional network defined in the Franchise Agreement.

In 2016, the City Auditor discovered that AT&T and Comcast did not consistently calculate the fees due in accordance with DIVCA and the municipal code of each of the cable joint powers members. As a result of the audit, the City received a settlement from AT&T in the amount of \$75,647 in 2016. The City has reached a tentative settlement with Comcast in the amount of \$25,000 and expects to receive payment in 2018.

The settlements and grant have been deposited and are being held by the City and earning interest. The City has since spent a part of the balance on various projects including installing and maintaining the institutional network equipment. As of December 31, 2017 and 2016, the remaining balance on deposit with the City, including \$2,642 and \$2,772, respectively, in interest receivable, was \$963,535 and \$1,175,502, respectively.

**NOTE 3 –SUBSEQUENT EVENT**

*Distribution to Members*

Subsequent to the fiscal year ended December 31, 2017, the Franchise distributed the franchise fee for the quarter ended December 31, 2017 of \$239,029 to its members in January 2018.

**PALO ALTO PUBLIC IMPROVEMENT  
CORPORATION**

(A Component Unit of the City of Palo Alto)

Annual Financial Report  
For the Year Ended June 30, 2018



Certified  
Public  
Accountants

**PALO ALTO PUBLIC IMPROVEMENT CORPORATION**  
**(A Component Unit of the City of Palo Alto)**  
For the Year Ended June 30, 2018

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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 financial statements of the governmental activities and the major fund of Palo Alto Public Improvement Corporation (Corporation), a component unit of the City of Palo Alto, California (City), as of and for the year ended June 30, 2018, and the related notes to the financial statements, which collectively comprise the Corporation's basic financial statements as listed in the table of contents.

### ***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### ***Auditor's Responsibility***

Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

### ***Opinions***

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and the major fund of the Corporation as of June 30, 2018, and the respective changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

***Other Matters******Required Supplementary Information***

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3 through 4 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

A handwritten signature in black ink that reads "Macias Gini & O'Connell LLP". The signature is written in a cursive, flowing style.

Walnut Creek, California  
November 19, 2018

**PALO ALTO PUBLIC IMPROVEMENT CORPORATION**  
**(A Component Unit of the City of Palo Alto)**  
 Management's Discussion & Analysis (Unaudited)  
 For the Year Ended June 30, 2018

The Palo Alto Public Improvement Corporation (Corporation), a component unit of the City of Palo Alto (City), follows the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34 (GASB 34), *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*. The Corporation is controlled by the City 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 one debt issue outstanding and has turned the proceeds over to the City, which pledged certain lease payments as collateral for this debt as discussed in Note 4 to the financial statements.

### **FISCAL YEAR 2018 FINANCIAL HIGHLIGHTS**

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

In fiscal year 2002, the Corporation issued its 2002B Downtown Parking Improvements Certificates of Participation (2002B COPs) in the amount of \$3.6 million. On June 1, 2018, the City issued 2018 Capital Improvement Project Certificates of Participation; 2002B Refinancing (2018 COPs) in the amount of \$9.0 million to refinance the remaining balance of the 2002B COPs, in the amount of \$805,000, and to provide new funding for the costs of the Palo Alto Municipal Golf Course renovations.

As of June 30, 2018, the 2018 COPs comprise the Corporation's outstanding debt.

At the government-wide level, interest and fiscal agent charges were \$308 thousand for fiscal year 2018, an increase of \$237 thousand from the prior year. The increase is primarily due to \$223 thousand in issuance costs in connection with the issuance of the 2018 COPs. The interest on leases on the assets securing this COP issue was \$91 thousand, an increase of \$17 thousand from the prior year. Interest and fiscal agent charges exceeded the interest on leases from the City by \$215 thousand, thereby resulting in a decrease in net position of \$215 thousand over the prior year.

The Corporation ended fiscal year 2018 with total assets of \$9.0 million, an increase of \$7.8 million from the prior year. The increase in assets result primarily from the issuance of the 2018 COPs of \$9.0 million offset by the reduction in cash held by trustee of \$237 thousand that was used for the refunding of 2002B COPs. Total assets consist of \$15 thousand in cash and investments and \$9.0 million of leases receivable from the City of Palo Alto. Total liabilities were \$9.0 million, an increase of \$8.0 million from the prior year due to the issuance of 2018 COPs.

At the fund level, the Corporation's expenditures exceeded revenues by \$8.4 million due to lease proceeds to the City of Palo Alto relating to the issuance of 2018 COPs. As of June 30, 2018, the Corporation had one fund, the Debt Service Fund, which reported a \$16 thousand restricted fund balance.



**PALO ALTO PUBLIC IMPROVEMENT CORPORATION**  
**(A Component Unit of the City of Palo Alto)**  
Management's Discussion & Analysis (Unaudited)  
For the Year Ended June 30, 2018

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

The annual financial report is comprised of two parts:

- 1) Management's discussion and analysis (this part),
- 2) The basic financial statements, which include the government-wide and the fund financial statements, along with the notes to these financial statements.

The basic financial statements comprise the government-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 positions, both short-term and long-term.

The government-wide financial statements provide a long-term view of the Corporation's activities as a whole, and comprise the statement of net position and the statement of activities. The statement of net position 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 expenses 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 position for the year.

The fund financial statements report the Corporation's operations in more detail than the corporate-wide statements and focus primarily on the short-term activities of the debt service fund. Fund financial statements measure only current revenues and expenditures; current assets, liabilities and fund balances; and they exclude capital assets and long-term debt.

Together, these statements along with the notes to the financial statements are called the basic financial statements.

## **DEBT ADMINISTRATION**

The Corporation issues debt in the form of COPs for 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.

As of June 30, 2018, the Corporation has one outstanding debt related to the 2018 Capital Improvement Project with an outstanding balance of \$9.0 million.

## **ECONOMIC OUTLOOK AND MAJOR INITIATIVES**

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

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

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

**PALO ALTO PUBLIC IMPROVEMENT CORPORATION**  
**(A Component Unit of the City of Palo Alto)**  
Statement of Net Position  
June 30, 2018

**Assets**

Cash and investments held for operations	\$ 15,210
Cash and investments held by trustee	297
Interest receivable	84
Lease interest receivable	28,661
Investment in leases to the City of Palo Alto	8,970,000
Total assets	<u>9,014,252</u>

**Liabilities**

Interest payable	28,661
Long-term debt:	
Due in one year	35,000
Due in more than one year	8,935,000
Total liabilities	<u>8,998,661</u>

**Net Position**

Restricted for debt service	<u>\$ 15,591</u>
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See accompanying notes to financial statements.

**PALO ALTO PUBLIC IMPROVEMENT CORPORATION**  
**(A Component Unit of the City of Palo Alto)**  
Statement of Activities  
For the Year Ended June 30, 2018

**Expenses**

Interest and fiscal agent charges	\$ 307,737
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**Program revenues**

Interest on leases from the City of Palo Alto	90,983
	(216,754)

**General revenues**

Investment earnings	1,945
---------------------	-------

Change in net position	(214,809)
------------------------	-----------

Net position, beginning of the year	230,400
-------------------------------------	---------

Net position, end of the year	\$ 15,591
-------------------------------	-----------

See accompanying notes to financial statements.

**PALO ALTO PUBLIC IMPROVEMENT CORPORATION****(A Component Unit of the City of Palo Alto)**

Balance Sheet  
Debt Service Fund  
June 30, 2018

**Assets**

Cash and investments held for operations	\$ 15,210
Cash and investments held by trustee	297
Interest receivable	84
Lease interest receivable	28,661
Investment in leases to City of Palo Alto	8,970,000
Total assets	<u>\$ 9,014,252</u>

**Deferred Inflows of Resources**

Unavailable lease receipts from the City of Palo Alto	\$ 8,998,661
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**Fund balance**

Restricted for debt service	<u>15,591</u>
Total deferred inflows of resources and fund balance	<u>\$ 9,014,252</u>

**Reconciliation of fund balance to net position**

Fund balance restricted for debt service	\$ 15,591
Long-term receivables are not available to pay for current period expenditures and are considered unavailable on the governmental fund balance sheet	8,998,661
Some liabilities, including bonds payable, are not due and payable in the current period and therefore are not reported in the Fund:	
Interest payable	(28,661)
Long-term debt due within one year	(35,000)
Long-term debt due in more than one year	<u>(8,935,000)</u>
Net position of governmental activities	<u>\$ 15,591</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 Balance  
Debt Service Fund  
For the Year Ended June 30, 2018

## Revenues:

Lease receipts from the City of Palo Alto:	
Principal	\$ 170,000
Interest	63,375
Investment earnings	1,945
Total revenues	<u>235,320</u>

## Expenditures:

Lease proceeds to the City of Palo Alto	8,166,053
Debt service:	
Principal repayment	170,000
Interest and fiscal agent charges	77,038
Costs of issuance	223,163
Total expenditures	<u>8,636,254</u>

Excess of Revenues over Expenditures	(8,400,934)
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## Other Financing Sources (Uses):

Issuance of Debt	8,970,000
Deposit with escrow agent	(805,000)
Total other financing sources (uses)	<u>8,165,000</u>

Net change in fund balance	(235,934)
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Fund balance, beginning of the year	<u>251,525</u>
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Fund balance, end of the year	<u><u>\$ 15,591</u></u>
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**Reconciliation of net change in fund balance to change in net position**

Net change in fund balance - debt service fund	\$ (235,934)
--	--------------

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

Repayment of bond principal is an expenditure in the governmental funds, but in the statement of net position the repayment reduces long-term liabilities.	170,000
--	---------

Amounts related to 2018 COPs refunding of 2002B COPs

Lease proceeds to the City of Palo Alto	8,166,053
Proceeds from issuance of 2018 COPs	(8,970,000)
Deposit with escrow agent for refunding of 2002B COPs	805,000

Some amounts reported in the statement of revenues, expenditures and changes in fund balances reflect the collection of an asset which are not includable as revenues and expenses on the statement of activities.

Lease principal paid related to 2002B COPs prior to refunding	(170,000)
Change in lease interest receivable	27,608
Change in interest payable	<u>(7,536)</u>

Change in net position of governmental activities	<u><u>\$ (214,809)</u></u>
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See accompanying notes to financial statements.

**PALO ALTO PUBLIC IMPROVEMENT CORPORATION**

**(A Component Unit of the City of Palo Alto)**

Notes to the Basic Financial Statements

For the Year Ended June 30, 2018

**NOTE 1 – DESCRIPTION OF REPORTING ENTITY**

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

The Corporation is an integral part of the City of Palo Alto (City). 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, 2018.

**NOTE 2 – SIGNIFICANT ACCOUNTING POLICIES**

**(a) Basis of Presentation**

**Government-wide Statements:** The statement of net position 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 investment earnings, are presented as general revenues.

**Fund Financial Statements:** The fund financial statements provide information about the Corporation's funds. The emphasis of fund financial statements is on major individual funds, of which the Corporation only reports one debt service fund.

**(b) Major Fund**

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

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

**(c) Investment in Leases**

Improvements financed by the Corporation are leased to the City for their entire estimated useful life and will become the City property at the conclusion of the lease on November 1, 2047. The Corporation therefore records the present value of the lease and considers the leased improvement to have been sold for this amount when leased.

**PALO ALTO PUBLIC IMPROVEMENT CORPORATION**  
**(A Component Unit of the City of Palo Alto)**  
Notes to the Basic Financial Statements  
For the Year Ended June 30, 2018

**NOTE 2 – SIGNIFICANT ACCOUNTING POLICIES (continued)**

**(d) Net Position**

The government-wide financial statements utilize a net position presentation. Net position is further categorized as net investment in capital assets, restricted and/or unrestricted. As of June 30, 2018, the entire net position was considered restricted.

*Restricted Net Position* – This category presents external restrictions imposed by creditors, grantors, contributors or laws or regulations of other governments and restrictions imposed by law through constitutional provisions or enabling legislation.

**(e) Deferred Inflows of Resources**

A deferred inflow of resources is defined as an acquisition of net position or fund balances applicable to a future reporting period and will not be recognized as an inflow of resources (revenue) until that time. On the governmental fund balance sheet, the lease receipts from the City corresponding to the debt are recorded as deferred inflows of resources since the balances are not current financial resources. The City considers revenues susceptible to accrual to be available if the revenues are collected within ninety days after year-end, except for property taxes, which are available if collected within sixty days after year-end.

**(f) Fund Balances**

At June 30, 2018, the Corporation's governmental fund's fund balances include the following classification:

*Restricted Fund Balance* – includes amounts that can be spent only for the specific purposes stipulated by external resource providers, constitutionally or through enabling legislation. Restrictions may effectively be changed or lifted only with the consent of resource providers.

**(g) Estimates**

The preparation of basic financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

**PALO ALTO PUBLIC IMPROVEMENT CORPORATION**  
**(A Component Unit of the City of Palo Alto)**  
Notes to the Basic Financial Statements  
For the Year Ended June 30, 2018

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

**(a) Interest Rate Risk**

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

<u>Investment Type</u>	<u>Amount</u>	<u>Maturity Date</u>
Money Market Mutual Fund	\$ 297	34 days

**(b) Credit Risk**

Generally, credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. This is measured by the assignment of a rating by a nationally recognized statistical rating organization. As of June 30, 2018, the Corporation's investments in money market mutual funds are rated AAAm by Standard & Poor's.

**(c) Fair Value Hierarchy**

The City categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. The hierarchy is based on the valuation inputs used to measure fair value of the assets. Level 1 inputs are quoted prices in an active market for identical assets; Level 2 inputs are significant other observable inputs; and Level 3 inputs are significant unobservable inputs. The Corporation's investments in money market mutual funds are not subject to the fair value hierarchy.

**(d) Investment Policy**

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

The table below identifies the investment types that are authorized by the City's Investment Policy. The table also identifies certain provisions of the City's Investment Policy that address interest rate risk, credit risk and concentration of credit risk.



**PALO ALTO PUBLIC IMPROVEMENT CORPORATION****(A Component Unit of the City of Palo Alto)**

Notes to the Basic Financial Statements

For the Year Ended June 30, 2018

**NOTE 3 – CASH AND INVESTMENTS HELD BY TRUSTEE (continued)**

Authorized Investment Type	Maximum Maturity	Minimum Credit Quality	Maximum Percentage of Portfolio	Maximum Investment in One Issuer
U.S. Government Securities	10 years (*)	N/A	No Limit	No Limit
U.S. Government Agency Securities	10 years (*)	N/A	No Limit (A)	No Limit
Certificates of Deposit	10 years (*)	N/A	20%	10% of the par value of portfolio
Bankers Acceptances	180 days	N/A	30%	\$5 million
Commercial Paper	270 days	P-1/A-1+	15%	\$3 million (B)
Local Agency Investment Fund	N/A	N/A	No Limit	\$50 million per account
Short-Term Repurchase Agreements	1 year	N/A	No Limit	No Limit
City of Palo Alto Bonds	N/A	N/A	No Limit	No Limit
Money Market Deposit Accounts	N/A	N/A	No Limit	No Limit
Mutual Funds	N/A	N/A	20%	10%
Negotiable Certificates of Deposit	10 years (*)	N/A	10%	\$5 million
Medium-Term Corporate Notes	5 years	AA	10%	\$5 million
Bonds of State of California Municipal Agencies	10 years (*)	AA/AA2	20%	No Limit

(A) Callable and multi-step securities are limited to no more than 25% of the par value of the portfolio, provided that: 1) the potential call dates are known at the time of purchase, 2) the interest rates at which they "step-up" are known at the time of purchase, 3) the entire face value of the security is redeemed at the call date.

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

(\*) The maximum maturity is based on the Investment Policy that is approved by the City Council and is less restrictive than the California Governmental Code.

**NOTE 4 – CERTIFICATES OF PARTICIPATION**

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

	Balance June 30, 2017	Additions	Retirements	Balance June 30, 2018	Amount due in one year
<b>Certificates of Participation</b>					
2018 Capital Improvement Projects 2.20-4.22%, due 11/1/2047	\$ -	\$ 8,970,000	\$ -	\$ 8,970,000	\$ 35,000
2002B Downtown Parking 6.50%; due 03/01/2022	975,000		975,000	-	-
<b>Total</b>	<b>\$ 975,000</b>	<b>\$ 8,970,000</b>	<b>\$ 975,000</b>	<b>\$ 8,970,000</b>	<b>\$ 35,000</b>

**PALO ALTO PUBLIC IMPROVEMENT CORPORATION**  
**(A Component Unit of the City of Palo Alto)**

Notes to the Basic Financial Statements  
For the Year Ended June 30, 2018

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

On January 16, 2002, the Corporation issued the 2002B Downtown Parking Improvements Certificates of Participation (2002B COPs) in the amount of \$3.6 million to finance the construction of certain improvements to the non-parking area contained in the City's Bryant/Florence Garage complex. Principal payments were due annually on March 1 and interest payments were due semi-annually on March 1 and September 1 and are payable from lease revenues received from the City.

On June 1, 2018, the City issued the 2018 Capital Improvement Projects and Refunding Certificates of Participation (2018 COPs) in the amount of \$9.0 million to fully refinance the 2002B COPs and provide new funding to finance the costs for the renovation of the Palo Alto Municipal Golf Course. Principal payments are due annually on November 1 and interest payments semi-annually at various rates on May 1 and November 1. The 2018 COPs are secured by lease revenues received by the Corporation from any City of Palo Alto General Fund revenue source.

Future annual debt service on the 2002B COPs is shown below:

For the Year Ending June 30,	Principal	Interest Payment	Total Payment
2019	\$ 35,000	\$ 319,602	\$ 354,602
2020	180,000	350,205	530,205
2021	185,000	345,165	530,165
2022	190,000	339,651	529,651
2023	195,000	333,749	528,749
2024-2028	1,070,000	1,565,383	2,635,383
2029-2033	1,285,000	1,345,453	2,630,453
2034-2038	1,565,000	1,060,046	2,625,046
2039-2043	1,915,000	702,749	2,617,749
2044-2048	2,350,000	256,365	2,606,365
	\$ 8,970,000	\$ 6,618,368	\$ 15,588,368

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

Independent Auditor's Report  
and Financial Statements

For the Year Ended  
June 30, 2018



Certified  
Public  
Accountants

**CITY OF PALO ALTO**  
**REGIONAL WATER QUALITY CONTROL PLANT**  
For the Year Ended June 30, 2018

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## Independent Auditor's Report

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

We have audited the accompanying financial statements of the City of Palo Alto Regional Water Quality Control Plant (Plant), an enterprise operation of the City of Palo Alto, California, for the year ended June 30, 2018, and the related notes to the financial statements, which collectively comprise the Plant's financial statements as listed in the table of contents.

### *Management's Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the financial reporting provisions of the Basic Agreement between the City of Palo Alto, the City of Mountain View and the City of Los Altos for the Acquisition, Construction and Maintenance of a Joint Sewer System, dated October 10, 1968, as amended by addenda dated December 5, 1977, January 14, 1980, April 9, 1985, May 30, 1991, July 31, 1992, March 16, 1998, April 15, 2009 and October 17, 2016 (collectively, the "Basic Agreement"), as described in Note 2 to the financial statements. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### *Opinion*

In our opinion, the financial statements referred to above present fairly, in all material respects, the revenues, expenditures and quarterly billings of the Plant for the year ended June 30, 2018, in accordance with the financial reporting provisions of the Basic Agreement as described in Note 2 to the financial statements.

***Basis of Accounting***

As discussed in Note 2 to the financial statements, the financial statements are prepared in accordance with the financial reporting provisions of the Basic Agreement, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

***Restriction on Use***

This report is intended solely for the information and use of the City Council and management of the Cities of Palo Alto, Mountain View and Los Altos, and is not intended to be and should not be used by anyone other than these specified parties.

*Macias Gini & O'Connell LLP*

Walnut Creek, California  
November 19, 2018

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

Statement of Net Expenditures  
For the Year Ended June 30, 2018

	Total	City of Mountain View	City of Los Altos	City of Palo Alto
Direct Expenditures:				
Source control program	\$ 1,427,323	\$ 543,952	\$ 148,442	\$ 734,929
Public outreach	134,707	51,337	14,010	69,360
Permitting and enforcement	1,081,971	278,129	16,628	787,214
Operations and maintenance	13,989,620	5,337,360	1,453,926	7,198,334
System improvement CIP (Note 3)	3,623,291	1,380,836	376,822	1,865,633
Total Direct Expenditures	20,256,912	7,591,614	2,009,828	10,655,470
Indirect Administrative Expenditures (Note 4):				
Source control program	946,273	360,625	98,412	487,236
Public outreach	1,673	638	174	861
Permitting and enforcement	341,821	256,734	15,348	69,739
Operations and maintenance	3,687,423	1,405,276	383,492	1,898,655
Total Indirect Administrative Expenditures	4,977,190	2,023,273	497,426	2,456,491
Debt Service Expenditures (Note 5):				
Refunding 1990 Series A Bonds	282,460	144,055	22,032	116,373
1999 Wastewater Treatment New Project	544,869	206,451	51,599	286,819
2009 State Water Resource Loan	555,726	210,565	52,627	292,534
Total Debt Service Expenditures	1,383,055	561,071	126,258	695,726
Total Expenditures	26,617,157	10,175,958	2,633,512	13,807,687
Deduct Joint Systems Revenues (Note 6)	(282,947)	(107,831)	(29,427)	(145,689)
Net Expenditures	\$ 26,334,210	\$ 10,068,127	\$ 2,604,085	\$ 13,661,998

See accompanying notes to the financial statements.

**CITY OF PALO ALTO**  
**REGIONAL WATER QUALITY CONTROL PLANT**  
Statement of Quarterly Billings  
For the Year Ended June 30, 2018

	<u>City of Mountain View</u>	<u>City of Los Altos</u>
Billings by Quarter, Beginning:		
July 1, 2017	\$ 2,478,936	\$ 612,411
October 1, 2017	2,741,197	675,883
January 1, 2018	2,478,936	612,411
April 1, 2018	<u>2,777,694</u>	<u>675,143</u>
Total billings	10,476,763	2,575,848
Net expenditures	<u>10,068,127</u>	<u>2,604,085</u>
Excess of total billings over net expenditures	<u><u>\$ 408,636</u></u>	<u><u>\$ (28,237)</u></u>

See accompanying notes to the financial statements.



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

Notes to the Financial Statements  
For the Year Ended June 30, 2018

**NOTE 1 – THE REPORTING ENTITY**

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 share 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, as set forth in the Basic Agreement between the City of Palo Alto, the City of Mountain View and the City of Los Altos (collectively, the “Members”) for the Acquisition, Construction and Maintenance of a Joint Sewer System dated October 10, 1968, as amended by addenda dated December 5, 1977, January 14, 1980, April 9, 1985, May 30, 1991, July 31, 1992, March 16, 1998, April 15, 2009 and October 17, 2016 (collectively, the “Basic Agreement”). The Basic Agreement will terminate on December 31, 2060, unless a written notice of withdrawal is tendered ten years preceding the date of withdrawal.

Effective October 17, 2016, the Members entered into an amendment to approve the projects for planning and design of the primary sedimentation tanks, the fixed film reactors, a new laboratory and Environmental Service building, and the design and construction of a sludge dewatering and load-out facility (the Projects). The Members also authorized the City to pursue State Revolving Fund loans from the State Water Resources Control Board to fund the costs of the Projects.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

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 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, joint system revenues, debt service and industrial waste compliance expenditures are shared by the Members based on agreed upon allocation percentages. The expenditures, including indirect administrative expenditures (see Note 4), 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. Revenues from services, fines and penalties are allocated to each of the Members in the same proportions as those of expenditures. 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 on upon the number of industries and efforts required to maintain compliance with sewage use ordinances and other regulations from Environmental Protection Agency.

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

Notes to the Financial Statements  
For the Year Ended June 30, 2018

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

The percentages used for the year ended June 30, 2018, to allocate expenditures and revenues were as follows:

	<u>City of Mountain View</u>	<u>City of Los Altos</u>	<u>City of Palo Alto</u>
Public outreach, source control program, operations and maintenance, system improvement CIP, and joint system revenues	38.11%	10.40%	51.49%
Debt services expenditures:			
1999 Utility Refunding Bonds			
1999 Wastewater Treatment New Project	37.89%	9.47%	52.64%
Refunding 1990 Series A Bonds	51.00%	7.80%	41.20%
2009 State Water Resources Loan	37.89%	9.47%	52.64%
Permitting and enforcement	37.56%	2.25%	60.19%

The City is allocated 51.49% 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 2018 allocations are as follows:

East Palo Alto Sanitary District	7.16%
Stanford University	7.03%
Town of Los Altos Hills	1.93%
Remaining City percentages	35.37%
Total	<u>51.49%</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 are offset against the payments during the second quarter of the subsequent fiscal year.

**NOTE 3 – SYSTEM IMPROVEMENT CIP**

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 operations. Per an addendum to the agreement dated March 16, 1998, the Members agreed that capital additions should 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. For fiscal year 2018, the adjusted capital additions limit is \$3,007,887. Actual System Improvement CIP expenditures amounted to \$3,623,291 for fiscal year 2018. As of June 30, 2018, the commitments for minor capital additions, including unspent capital additions from previous years, was \$4,226,766, of which encumbrances in the amount of \$1,933,208 have been carried forward to fiscal year 2019.

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

Notes to the Financial Statements  
For the Year Ended June 30, 2018

**NOTE 3 – SYSTEM IMPROVEMENT CIP (Continued)**

As of June 30, 2018, the City also committed \$14,476,821 for major projects such as the Plant Master Plan and Dewatering and Loadout Facility project that was approved in October 2016. These commitments are not subject to the minor capital addition limit.

**NOTE 4 – INDIRECT ADMINISTRATIVE 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 Services Funds. These allocations are applied on a uniform basis throughout the City. The allocations are applied in accordance with the subsequent letter of agreement dated April 9, 1985.

**NOTE 5 – DEBT SERVICE EXPENDITURES**

Debt service expenditures include principal repayments, interest expense and amortization of bond discount reduced by any interest income earned from investments with the fiscal agent, related to the 1999 Series A Bonds (split for the portions used for the "New Project" and refunding of the 1990 Series A Bonds) and the 2009 State Water Resources loan.

In prior years, the City, City of Mountain View, City of Los Altos, Town of Los Altos Hills, East Palo Alto Sanitary District, and Stanford University agreed to issue bonds (1999 Series A Bonds) to finance the rehabilitation of the Wastewater Treatment System's two sludge incinerators and to refund the 1990 Series A Bonds. In October 2009, the City approved the 2009 State Water Resources Loan to finance the Ultraviolet Disinfection Project. The principal amount of the debt outstanding as of June 30, 2018 are allocated as follows:

	1999 Utility Revenue Refunding Bonds			
	1999 Wastewater Treatment New Project	Refunding of 1990 Series A Bonds	2009 State Water Resources Loan	Total
City of Palo Alto	\$ 1,022,688	\$ 351,970	\$ 2,314,100	\$ 3,688,758
City of Mountain View	1,015,452	718,019	2,297,727	4,031,198
City of Los Altos	253,796	109,815	574,280	937,891
East Palo Alto Sanitary District	204,752	167,538	463,305	835,595
Stanford University	140,968	57,723	318,977	517,668
Town of Los Altos Hills	42,344	2,815	95,814	140,973
Total	<u>\$ 2,680,000</u>	<u>\$ 1,407,880</u>	<u>\$ 6,064,203</u>	<u>\$ 10,152,083</u>

As required by the Indenture of the 1999 Series A Bonds, the City established a debt service reserve fund (the Reserve Account), with a minimum funding level requirement in the Reserve Account (the Reserve Requirement). At the time the bond issuance, the City satisfied the Reserve Requirement with a deposit into the Reserve Account of a surety bond in the amount of \$1,647,300 issued by Ambac Assurance Corporation.

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

Notes to the Financial Statements  
For the Year Ended June 30, 2018

**NOTE 5 – DEBT SERVICE EXPENDITURES (Continued)**

**2017 State Water Resources Loan** - In June 2017, the State Water Resources Control Board (SWRCB) and the City executed an agreement for an award up to \$30 million, 30 years at 1.8% to finance the project replacing the sewage sludge “bio-solids” incinerators at the Plant. Under the terms of the contract, a portion of the loan amount, \$4 million, has been forgiven due to the City’s performance of its obligations under the agreement. On September 13, 2017, the City and SWRCB amended the original agreement of the 2017 SRF loan to lower the total amount to \$29.7 million and the due date of the last debt service payment be May 31, 2049.

The new facility will dewater the bio-solids and allow it to be loaded onto trucks and taken offsite for further treatment until further treatment units can be build onsite. The Plant provides treatment and disposal for wastewater for the City, City of Mountain View, City of Los Altos, Town of Los Altos Hills, East Palo Alto Sanitary District, and Stanford University. Though the City is the recipient of the loan, the City’s agreement with the partner agencies oblige them to pay their proportionate share of the principal and interest of this loan. The City’s share of the loan payment is 38.2% with the partner agencies paying 61.8%. Per the SWRCB agreement, the first debt service payment of this loan is due on May 31, 2020, a year after the project is expected to be completed.

**NOTE 6 – JOINT SYSTEM REVENUES**

The Plant’s joint system revenues for the year ended June 30, 2018 total \$282,947, which consisted of the following:

Septic hauling services	\$ 241,565
Other miscellaneous revenues	4,193
Salt water marsh services	7,500
Utility service to other utility funds	29,689
	<u>\$ 282,947</u>

**NOTE 7 – RELATED PARTY TRANSACTIONS**

During fiscal year 2018, the Plant paid the City \$3,090,929 for utility costs. Such costs are included in the Statement of Net Expenditures as source control program, permitting and enforcement, and operations and maintenance expenditures. Vehicle replacement charges of \$70,534 were paid to the City’s Equipment Replacement Fund, which is included in the Statement of Net Expenditures as operations and maintenance expenditures.

**CITY OF PALO ALTO, CALIFORNIA**

Independent Accountant's Report on Applying  
Agreed-Upon Procedures Related to  
the Article XIII-B Appropriations Limit

For the Year Ended June 30, 2018



Certified  
Public  
Accountants

**Independent Accountant's Report on  
Applying Agreed-Upon Procedures Related to  
the Article XIII-B Appropriations Limit**

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

We have performed the procedures enumerated below to the accompanying Appropriations Limit Worksheet of the City of Palo Alto, California (City), which were agreed to by the City and recommended by the California Committee on Municipal Accounting (CCMA) (as presented in the CCMA White Paper titled *Agreed-upon Procedures Applied to the Appropriations Limitation Prescribed by Article XIII-B of the California Constitution*), on the City's calculation of the appropriations limit in accordance with Section 1.5 of Article XIII-B of the California Constitution for the year ended June 30, 2018. The City management is responsible for the Appropriation Limit Worksheet. The sufficiency of these procedures is solely the responsibility of the City's Management. 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.

The procedures and associated findings are as follows:

1. We obtained the completed worksheets setting forth the calculations necessary to establish the City's appropriations limit and compared the limit and annual adjustment factors included in those worksheets to the limit and annual adjustment factors that were adopted by resolution of the City Council. We also compared the population and inflation options included in the aforementioned worksheets to those that were selected by a recorded vote of the City Council.

Finding: No exceptions were found as a result of applying the procedure.

2. For the accompanying Appropriations Limit Worksheet, we added prior year appropriations limit to total adjustments, and compared the resulting amount to the current year appropriations limit.

Finding: No exceptions were found as a result of applying the procedure.

3. We compared the current year information presented in the accompanying Appropriations Limit Worksheet to the worksheets described in No. 1 above.

Finding: No exceptions were found as a result of applying the procedure.

4. We compared the prior year appropriations limit presented in the accompanying Appropriations Limit Worksheet to the prior year appropriations limit adopted by the City Council.

Finding: No exceptions were found as a result of applying the procedure.

This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. We were not engaged to and did not conduct an examination or review, the objective of which would be the expression of an opinion or conclusion, respectively, on the Appropriations Limit Worksheet. Accordingly, we do not express such an opinion or conclusion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you. No procedures have been performed with respect to the determination of the appropriations limit for the base year, as defined by Article XIII-B of the California Constitution.

This report is intended solely for the information and use of the City Council and City management and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

*Macias Gini & O'Connell LLP*

Walnut Creek, California  
November 19, 2018

**CITY OF PALO ALTO, CALIFORNIA**  
**Appropriations Limit Worksheet**  
**For the Year Ended June 30, 2018**

2016-2017 appropriations limit, as adopted	\$ 151,481,281
Adjustment factors:	
Population	1.0082
Inflation	1.0369
Total adjustment factors (rounded)	<u>1.0454</u>
Total adjustments	<u>6,877,641</u>
2017-2018 appropriation limit, as adopted	<u>\$ 158,358,922</u>