



## CITY COUNCIL STAFF REPORT

**From: City Manager**

**Report Type: CONSENT REPORT**

**Lead Department: Administrative Services**

**Meeting Date: January 23, 2023**

### TITLE

Acceptance of the Macias Gini & O'Connell Audit of the City of Palo Alto's Financial Statements as of June 30, 2022 and the Management Letter; Approval of the FY 2022 Annual Comprehensive Financial Report (ACFR); and Amendments to the FY 2022 Budget in Various Funds, as Recommended by the Finance Committee

### RECOMMENDATION

Finance Committee and Staff recommend that the City Council:

1. Accept the City of Palo Alto's audited financial statements for the fiscal year ended June 30, 2022, and the accompanying reports provided by Macias Gini & O'Connell ("MGO") LLP ([Office of the City Auditor Report](#)) Attachment I. Reports include:
  - a. Report to the City Council (the "Management Letter"),
  - b. Cable TV Franchise, Independent Auditor's Report and Statements of Franchise Revenues and Expenses for the years ended December 31, 2021, and 2020,
  - c. Palo Alto Public Improvement Corporation (a component unit of the City of Palo Alto) Annual Financial Report for the year ended June 30, 2022,
  - d. Regional Water Quality Control Plant, Independent Auditor's Report and Financial Statements for the year ended June 30, 2022,
  - e. Independent Accountant's Report on Applying Agreed-Upon Procedures related to the Article XIII-B Appropriations (GANN) Limit for the year ended June 30, 2022.
2. Approve the Fiscal Year (FY) 2022 Annual Comprehensive Financial Report (ACFR), included in CMR 14632<sup>1</sup>(Attachment B, packet page 53). An electronic copy is available on the City's website<sup>2</sup>.

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<sup>1</sup> 11/29/2022 Finance Committee Staff Report, Approval of the FY 2022 ACFR and YE Budget Amendments, pg. 53  
<https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/finance-committee/2022/20221129/20221129pfscsm-linked.pdf#page53>

<sup>2</sup> City of Palo Alto FY 2022 Annual Comprehensive Financial Report  
<https://www.cityofpaloalto.org/files/assets/public/administrative-services/financial-reporting/comprehensive-annual-financial-reports-cafr/current-2011-cafrs/2022-acfr-final/city-of-palo-alto-acfr-fy2022-final-secured-2.pdf>

3. Amend the Fiscal Year 2022 Budget Appropriation Ordinance for various funds as identified in CMR #14632<sup>3</sup> *Recommended Amendments to the City Manager's FY 2022 Budget* (Attachment B packet pages 73-82); Attachment B – Exhibit 1 and various capital projects as identified in Attachment B – Exhibit 2. (Effective on first reading; five votes required.)

Hard copies of linked reports within this recommendation are available upon request.

## **EXECUTIVE SUMMARY**

Every year, the fiscal year is closed out and the City Council publishes the City's financial report (PAMC 2.28.200). At its November 29, 2022, meeting, the Finance Committee unanimously approved closing of the 2022 fiscal year (Attachment III).

MGO issued a clean opinion on each audit report. The Appropriations Limit (or "Gann Limit") Agreed-Upon Procedures Report noted a finding regarding the calculation of the Gann Limit. The incorrect adjustment factor was used in the calculation; staff corrected the calculation and noted that the City's actual revenue did not exceed the corrected GANN Limit. These reports transmitted the City's FY 2022 financials through the Annual Comprehensive Financial Report (ACFR) for the year ending June 30, 2022. The City also received the Certificate of Achievement for Excellence in Financial Reporting from the Government Finance Officers Association for its FY 2021 ACFR.

In addition to the ACFR and audit reports, the report includes recommended budget adjustment actions to close the fiscal year. These actions adjust the budget to appropriate funds to align the budget with actual operating and capital activity, as well as adjust transfers between funds.

## **BACKGROUND**

At the November 29, 2022, Finance Committee meeting, the Committee reviewed two staff reports: one transmitted by the City Auditor's Office and one by the City Manager's Office via the Administrative Services Department, and unanimously approved both reports for City Council consideration:

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<sup>3</sup>11/29/2022 Finance Committee Staff Report, Approval of the FY 2022 ACFR and YE Budget Amendments, pg. 73-82  
<https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/finance-committee/2022/20221129/20221129pfscsm-linked.pdf#page73>

- Office of the City Auditor: Discussion and Recommendation to the City Council to Accept the Macias Gini & O’Connell’s (MGO) Audit of the City of Palo Alto’s Financial Statements as of June 30, 2022. CMR #14984<sup>4</sup> packet pages 4-52.
- Administrative Services Department: Recommendation to Approve the Fiscal Year (FY) 2022 Annual Comprehensive Financial Report (ACFR) and Approve FY 2022 Budget Amendments in Various Funds. CMR #14632 packet pages 53-83.

In addition to these reports, the Finance Committee reviewed recommended budget adjustment actions to close the fiscal year (Attachment II, Attachment B). The Finance Committee discussed the status of the General Fund and the Budget Stabilization Reserve (BSR) balance. Compared to estimates used in the development of the FY 2023 Adopted Budget, the General Fund ended with a net \$14.2 million BSR balance surplus above the Council target level of 18.5% of budgeted expenses. The BSR balance is \$72.8 million, a \$23.7 million or 48.3% increase compared to FY 2021. Please refer to the General Fund discussion in the Finance Committee staff report<sup>5</sup> for information regarding the primary drivers for these General Fund results.

The FY 2023 Adopted Operating Budget projected a \$54.7 million BSR balance as of June 30, 2022, compared to the actual balance of \$72.8 million. The BSR balance increase was driven by revenue trending higher than estimated in the City’s major tax categories and program expense, coupled with lower expenses across all departments (primarily staff costs due to vacancy). Much of this variance was forecasted and discussed as a core component of the FY 2023 Adopted Budget and two-year budget balancing strategy. Table 4 in the Finance Committee report<sup>6</sup> outlines the already approved uses of the BSR in FY 2023 and includes FY 2023 recommended adjustments to the BSR balance to be considered by the City Council during mid-year budget review scheduled in February 2023. Including the recommended adjustments to the BSR balance, the current projected BSR balance is \$45.8 million.

## **ANALYSIS**

### **Government-wide**

As outlined in the staff report to the Finance Committee, at the close of FY 2022, the City’s total Net Position is \$1.27 billion, an increase of \$40.6 million or 3.2% over the prior fiscal year. The

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<sup>4</sup> 11/29/2022 Discussion & Recommendation to the City Council to Accept MGO’s audit of the City’s FY 2022 Financial Statements. <https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/finance-committee/2022/20221129/20221129pfscsm-linked.pdf#page4>

<sup>5</sup> Finance Committee, November 29, 2022, Agenda Item #2, packet page 54  
<https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/finance-committee/2022/20221129/20221129pfscsm-linked.pdf#page=54>

<sup>6</sup> Finance Committee, November 29, 2022, Agenda Item #2, packet page 63  
<https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/finance-committee/2022/20221129/20221129pfscsm-linked.pdf#page=63>

total increase of \$40.6 million consists of \$51.0 million from governmental activities partially offset by a decrease of \$10.4 million from business-type activities.

The largest portion of the City's net position (\$1.175 billion or 92.4%) is its net investment in capital assets such as land, buildings, infrastructure, vehicles, and intangible assets – right to use leased assets less any related outstanding debt that was used to acquire these assets. The restricted portion of the City's net position (\$76.2 million or 6.0%) represents resources that are subject to external restrictions on how they may be used. The remaining balance of \$20.0 million, across all funds, representing 1.6% of the City's net position, is unrestricted and may be used to meet the City's ongoing obligations to its citizens and creditors.

### **General Fund**

General Fund ended with a \$72.8 million Budget Stabilization Reserve (BSR), a 23.7 percent, increase when compared to FY 2021. This increase is driven mainly by both actuals higher than budgeted revenues and actuals lower than budgeted expenditures (detailed in Attachment II packet page 72). Much of this variance was forecasted, discussed, and a core component of the FY 2023 Adopted Budget and two-year budget balancing strategy. The Council recognized these higher than budgeted estimate and used these funds to bridge the transition as the City and community emerged from the pandemic while ensuring stability for the organization. The chart below outlines the already approved uses of the BSR in FY 2023. These adjustments, totaling \$13.0 million, results in a BSR balance of \$59.8 million; approximately 24.2% of the FY 2022 Adopted expenses of \$247.4 million. This level is approximately \$14.2 million above the target level of 18.5% (\$45.6 million).

<b>Table 1: Year-End Budget Stabilization Reserve (BSR) Summary (in millions)</b>	
<b>General Fund BSR Balance, June 30, 2022</b>	<b>\$72,835</b>
<b>Uses of the FY 2022 Surplus</b>	
<i>FY 2023 Approved Adjustments to the BSR Balance</i>	
FY 2023 Adopted Budget	(\$9,072)
FY 2023 Services Reinvestment	(\$3,700)
Downtown Streets Team (CMR 14526)	(\$167)
Reappropriations (CMR 14728)	(\$100)
<b>Subtotal: Approved Adjustments to the BSR Balance</b>	<b>(\$13,039)</b>
<b>Subtotal: BSR Balance, After Approved Adjustments</b>	<b>\$59,796</b>
<b><i>FY 2023 RECOMMENDED Adjustments to the BSR Balance</i></b> <i>(to be considered in FY 2023 Mid-Year Budget)</i>	
Reserve for Economic Uncertainty	(\$5,000)
Transfer to Section 115 Pension Trust Fund	(\$5,000)

<b>Table 1: Year-End Budget Stabilization Reserve (BSR) Summary (in millions)</b>	
Transfer to Infrastructure Reserve (IR) in the Capital Improvement Fund	(\$4,000)
<b><i>Subtotal: RECOMMENDED Adjustments to the BSR Balance</i></b>	<b>(\$14,000)</b>
<b>Current Projected FY 2022 BSR Level, (June 30, 2023)</b>	<b>\$45,796</b>

Micro and macro-economic conditions are adjusting daily, with rising inflation, changes in jobs, and recessionary trends creating significant uncertainty. As the State of California Legislative Analyst Office (LAO) wrote in their annual Fiscal Outlooks for California “Economic Conditions Weigh on Revenues, [the] booming economy has led to high inflation...efforts to tame inflation are slowing the economy...inflation pressures remain, raising risk of recession...fiscal outlooks revenues balance competing risks<sup>7</sup>.” Therefore, the recommended adjustments outlined in Table 1 are in line with the City Manager’s authority for transfer of excess BSR, adjusted for a recommendation to reserve funds to safeguard the stability the City has strived to achieve in the recent year by re-establishing an economic uncertainty reserve. Staff anticipates returning to Council in February 2023 with the FY 2023 Mid-Year Review and recommendations in alignment with the allocation below for the appropriation of BSR funds above the 18.5% level. Staff recommends a transfer to the Infrastructure Reserve as inflationary costs are impacting capital project needs including anticipated significant price increases in the Automated Parking Guidance Project, as well as a need to provide safety improvements to critical assets such as the artificial turf playing fields.

#### ***Business Type Activities (Enterprise Funds & Internal Service Funds)***

As of June 30, 2022, the City’s Enterprise Funds reported a total net position of \$796.8 million, a decrease of \$10.4 million or 1.3% from the prior year. All funds showed positive balances: Net Investment in Capital Assets (\$670.8 million), Restricted for Debt Service (\$3.3 million), and Unrestricted (\$122.7 million).

Details that were presented at the November 29, 2022, meeting are included in Attachments I and II.

#### **FISCAL/RESOURCE IMPACT**

The actions recommended in CMR 14632 (Attachment II), Attachment B, both Exhibits 1 and 2, recommend adjustments to the FY 2022 appropriated level of funds to align budgeted levels with year-end activities. Overall, these transactions ensure all funds remain in a positive financial picture.

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<sup>7</sup> The 2023-24 Budget California’s Fiscal Outlook, California Legislative Analyst’s Office (LAO), November 16, 2022  
<https://lao.ca.gov/Publications/Report/4646>

## **STAKEHOLDER ENGAGEMENT**

This report has been prepared by the Administrative Service Department Accounting division and coordinated with the Office of the City Auditor and the Office of Management and Budget.

## **ENVIRONMENTAL REVIEW**

Council action on this item is not a project as defined by CEQA because the acceptance of the audited financial reports for the fiscal year ending June 30, 2022 , approval of the ACFR for Fiscal Year 2022, and the amendment to the Fiscal Year 2022 Budget Appropriation Ordinance are fiscal activities which do not involve any commitment to any specific project which may result in a potentially significant physical impact on the environment. CEQA Guidelines section 15378(b)(4).

## **ATTACHMENTS**

Attachment I: *Discussion and Recommendation to the City Council of the MGO's Audit of the City of Palo Alto's FY 2022 Financial Statements*

Attachment II: *Staff Report #14632, Approval of FY2022 ACFR & Budget Amendments*

Attachment III: *Action Minutes, Finance Committee 11/29/2022*

## **APPROVED BY:**

Kiely Nose, Assistant City Manager

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