CITY OF PALACIOS, TEXAS

ANNUAL FINANCIAL REPORT

For the year ended September 30, 2011

CITY OF PALACIOS, TEXAS
ANNUAL FINANCIAL REPORT
For the year ended September 30, 2011

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INTRODUCTORY SECTION

CITY OF PALACIOS, TEXAS
DIRECTORY OF PRINCIPAL OFFICIALS
September 30, 2011

City Officials	Elective Position
John Sardelich	Mayor
Ed Schulze	Mayor Pro-Tem
Andy Erdelt	Council Member
Mike Witte	Council Member
Gary Hafernick	Council Member
Estella Alamia	Council Member
Troy Lewis	Council Member

Key Staff	Appointive Position
Charles R. Winfield	City Manager
Randall B. Strong	City Attorney
Linh Chau	Municipal Court Judge
Keri Berger	City Secretary
Irma De Leon	City Treasurer

FINANCIAL SECTION

HARRISON, WALDROP & UHEREK, L.L.P.

HWU

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INDEPENDENT AUDITORS' REPORT

The Honorable Mayor and Members
of City Council
City of Palacios, Texas

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the discretely presented component unit, each major fund and the aggregate remaining fund information of the City of Palacios, Texas (the "City"), as of and for the year ended September 30, 2011, which collectively comprise the City's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City's management. Our responsibility is to express opinions on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component unit, and each major fund of the City as of September 30, 2011, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated February 10, 2012, on our consideration of the City's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis, budgetary comparison information and historical pension information on pages 4 through 10 and 45 through 48 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.

The Honorable Mayor and Members
of the City Council

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the City's financial statements as a whole. The introductory section, combining and individual major and nonmajor fund financial statements and schedules are presented for purposes of additional analysis and are not a required part of the financial statements. The combining and individual major and nonmajor fund financial statements and schedules are the responsibility of management and were derived from and relate directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole. The introductory section 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..

Harrison, Waldrop & Uhrik, LLP

February 10, 2012

As management of the City of Palacios, Texas (the "City"), we offer readers of the City's financial statements this narrative overview and analysis of the financial activities of the City for the fiscal year ended September 30, 2011.

FINANCIAL HIGHLIGHTS

- The assets of the City exceeded its liabilities at the close of the most recent fiscal year by $15,972,801 *(net assets).* Of this amount, $1,639,498 *(unrestricted net assets)* may be used to meet the City's ongoing obligations to citizens and creditors.
- As of the close of the current fiscal year, the City's governmental funds reported combined ending fund balances of $648,035, an increase of $200,707 from the prior year. At the end of the current fiscal year, unassigned fund balance for the General Fund was $554,618, or 24.51% of total General Fund expenditures.
- The City's total debt of business-type activities increased by $3,467,176 or 190.54% during the fiscal year, ending with a balance of $5,286,793 of which $221,328 is due within one year.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is intended to serve as an introduction to the City's basic financial statements. The City's basic financial statements are comprised of three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to financial statements. This report also contains other supplemental information in addition to the basic financial statements themselves.

Organization and Flow of Financial Section Information

Independent Auditors' Report
Provides the opinion of the Independent Auditors on the fair presentation of the basic financial statements.

Management's Discussion and Analysis
This supplementary information is required for state and local government financial statements and is intended to provide a narrative introduction and analysis.
Pages 4 to 10

Government-wide Financial Statements
Provides information on governmental and business-type activities of the primary government.
Pages 11 to 14

Fund Financial Statements
Provides information on the financial position of specific funds of the primary governments.
Pages 15 to 23

Notes to Financial Statements
Provides a summary of significant accounting policies and related disclosures.
Pages 24 to 44

OVERVIEW OF THE FINANCIAL STATEMENTS - (Continued)

Government-wide Financial Statements

The government-wide financial statements are designed to provide readers with a broad overview of the City's finances, in a manner similar to a private-sector business.

Statement of Net Assets

The statement of net assets presents information on all of the City's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the City is improving or deteriorating.

Statement of Activities

The statement of activities presents information showing how the City's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods (i.e., uncollected taxes and earned but unused vacation leave).

Both of the government-wide financial statements distinguish functions of the City that are principally supported by taxes and intergovernmental revenues *(governmental activities)* from other functions that are intended to recover all or a significant portion of their costs through user fees and charges *(business-type activities).* The governmental activities of the City include general government, public safety, public works, health and welfare, and special services. The business-type activities of the City include water/wastewater and airport services.

Fund Financial Statements

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The City, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All of the funds of the City can be divided into two categories: governmental funds or proprietary funds.

Governmental Funds

Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financing requirements.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

The City maintained thirteen individual governmental funds during the 2010-2011 fiscal year. Information is presented separately in the governmental funds balance sheet and in the governmental funds statement of revenues, expenditures, and changes in fund balances for the General Fund which is considered a major fund. Data from the other twelve governmental funds are combined into a single, aggregated presentation.

OVERVIEW OF THE FINANCIAL STATEMENTS - (Continued)

Governmental Funds - (Continued)

The City adopts an annual appropriated budget for its General Fund. A Schedule of Revenues, Expenditures, and Changes in Fund Balances - Budget and Actual has been provided to demonstrate compliance with the appropriated budget.

Proprietary Funds

The City maintains two different types of proprietary funds. Enterprise funds are used to report the same functions presented as business-type activities in the government-wide financial statements. The City uses enterprise funds to account for its water/wastewater utility service and for its airport operations. Internal service funds are an accounting device used to accumulate and allocate costs internally among a government's various functions. The City's internal service fund is the Equipment Fund, which is used to account for the costs to maintain the City's fleet.

Proprietary funds provide the same type of information as the government-wide financial statements, only in a more detailed format. The proprietary fund financial statements provide information for the water/wastewater utility service and the airport operation; which are considered to be major funds of the City.

Fiduciary Funds

Fiduciary funds are used to account for resources held for the benefit of parties outside the government. Fiduciary funds are not reflected in the government-wide financial statements because the resources of those funds are not available to support the City's own programs/operations. The accounting used for fiduciary funds is similar to proprietary funds.

Notes to Financial Statements

The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements.

Other Information

In addition to the basic financial statements and accompanying notes, required supplementary information is included which presents a budgetary comparison schedule for the City's General Fund.

The combining statements referred to earlier in connection with nonmajor governmental funds are presented immediately following the required supplementary information.

GOVERNMENT-WIDE FINANCIAL ANALYSIS

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. In the case of the City, net assets exceeded liabilities by $15,972,801 at the close of the fiscal year 2011.

By far, the largest portion of the City's net assets (89.74%) reflects its investment in capital assets (i.e., land, buildings, machinery and equipment), less a related debt used to acquire those assets that is still outstanding. The City uses these capital assets to provide services to its citizens; consequently, these assets are not available for future spending. Although the City's investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

GOVERNMENT-WIDE FINANCIAL ANALYSIS - (Continued)

City of Palacios, Texas

Net Assets

	Governmental Activities		Business-type Activities		Total	
	2011	2010	2011	2010	2011	2010
Current and other assets	$ 1,272,995	$ 939,102	$ 4,030,108	$ 633,634	$ 5,303,103	$ 1,572,736
Capital assets (net)	1,754,452	1,731,607	14,804,243	15,139,568	16,558,695	16,871,175
Other noncurrent assets	6,855	8,570	158,911	40,992	165,766	49,562
Total assets	3,034,302	2,679,279	18,993,262	15,814,194	22,027,564	18,493,473
Current liabilities	249,283	179,373	616,615	434,685	865,898	614,058
Noncurrent liabilities	123,400	160,900	5,065,465	1,600,965	5,188,865	1,761,865
Total liabilities	372,683	340,273	5,682,080	2,035,650	6,054,763	2,375,923
Invested in capital assets, net of related debt	1,593,552	1,534,907	12,739,751	13,368,087	14,333,303	14,902,994
Unrestricted	1,068,067	804,099	571,431	410,457	1,639,498	1,214,556
Total net assets	$ 2,661,619	$ 2,339,006	$ 13,311,182	$ 13,778,544	$ 15,972,801	$ 16,117,550

The balance of unrestricted net assets, $1,639,498, may be used to meet the government's ongoing obligations to its citizens and creditors.

At the end of the current fiscal year, the City is able to report positive balances in all categories of net assets for the primary government as a whole.

GOVERNMENT-WIDE FINANCIAL ANALYSIS - (Continued)

Governmental activities increased the City's net assets by $332,597. Business-type activities decreased the City's net assets by $467,172.

City of Palacios, Texas

Changes in Net Assets

	Governmental Activities		Business-type Activities		Total	
	2011	2010	2011	2010	2011	2010
REVENUES						
Program revenues:						
Charges for services	$ 97,329	$ 100,523	$ 2,302,329	$ 1,949,320	$ 2,399,658	$ 2,049,843
Operating grants and contributions	53,227	55,506	-	-	53,227	55,506
Capital grants and contributions	116,455	-	115,110	9,399,438	231,565	9,399,438
General revenues:						
Property taxes	1,249,492	1,150,478	-	-	1,249,492	1,150,478
Sales taxes	452,682	391,631	-	-	452,682	391,631
Franchise taxes	149,710	146,694	-	-	149,710	146,694
Other taxes	23,420	23,228	-	-	23,420	23,228
Unrestricted investment earnings	955	2,361	3,028	2,674	3,983	5,035
Miscellaneous	180,437	183,110	42,840	47,584	223,277	230,694
Total revenues	2,323,707	2,053,531	2,463,307	11,399,016	4,787,014	13,452,547
EXPENSES						
General government	735,576	692,744	-	-	735,576	692,744
Public safety	1,175,658	1,148,741	-	-	1,175,658	1,148,741
Public works	438,010	565,798	-	-	438,010	565,798
Special services	152,721	180,850	-	-	152,721	180,850
Health and welfare	62,883	63,484	-	-	62,883	63,484
Interest on long-term debt	13,526	10,800	-	-	13,526	10,800
Water and sewer	-	-	2,270,627	1,820,662	2,270,627	1,820,662
Airport	-	-	82,762	103,439	82,762	103,439
Total expenses	2,578,374	2,662,417	2,353,389	1,924,101	4,931,763	4,586,518
Change in net assets before transfers	(254,667)	(608,886)	109,918	9,474,915	(144,749)	8,866,029
Transfers	577,280	536,275	(577,280)	(536,275)	-	-
Change in net assets	322,613	(72,611)	(467,362)	8,938,640	(144,749)	8,866,029
Net assets - beginning	2,339,006	2,411,617	13,778,544	4,839,904	16,117,550	7,251,521
Net assets - ending	$ 2,661,619	$ 2,339,006	$ 13,311,182	$ 13,778,544	$ 15,972,801	$ 16,117,550

FINANCIAL ANALYSIS OF THE CITY'S FUNDS

As noted earlier, the City uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Governmental Funds

The focus of the City's governmental funds is to provide information on near-term inflows, outflows, and balances of spendable resources. Such information is useful in assessing the City's financing requirements. In particular, unassigned fund balance may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year.

As of the end of the current fiscal year, the City's governmental funds reported combined ending fund balances of $648,035, an increase of $200,707 from the prior year.

Approximately 85.58% of this total amount, $554,618 constitutes unassigned fund balance, which is available for spending at the City's discretion. The remainder of fund balance of $93,417 or 14.42% is nonspendable or restricted.

The General Fund is the chief operating fund of the City. At the end of the current fiscal year, unassigned fund balance was $554,618. Unreserved fund balance represents 24.51% of total General Fund expenditures.

The fund balance of the City's General Fund increased by $179,104 during the current fiscal year. The increase was primarily due to the increase in tax revenue.

Proprietary Funds

The City's proprietary funds provide the same type of information found in the government-wide financial statements, but in more detail.

Unrestricted net assets of the Water and Sewer Fund at the end of the current fiscal year amounted to $122,656. Unrestricted net assets of the Airport Fund amounted to $91,446 at the end of the current fiscal year, which is a decrease of $37,396 from the prior year.

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital Assets

The City's investment in capital assets for its governmental and business-type activities amounts to $16,558,694 (net of accumulated depreciation) at the end of the current fiscal year. This investment in capital assets includes land, buildings and improvements, vehicles, machinery and equipment, water and sewer system, and land structured facilities. The total decrease in the City's investment in capital assets was 1.85% (a 1.32% increase for governmental activities and a 2.21% decrease in business-type activities).

City of Palacios, Texas

Capital Assets (Net of Depreciation)

	Governmental Activities		Business-type Activities		Total	
	2011	2010	2011	2010	2011	2010
Land	$ 357,286	$ 357,286	$ 7,373	$ 7,373	$ 364,659	$ 364,659
Construction in progress	153,170	-	168,968	94,354	322,138	94,354
Buildings and improvements	594,908	611,210	575,532	665,976	1,170,440	1,277,186
Machinery and equipment	328,360	416,355	13,350	3,453	341,710	419,808
Land structured facilities	320,728	346,756	435,648	365,504	756,376	712,260
Water and sewer system	-	-	13,603,372	14,002,908	13,603,372	14,002,908
Total	$ 1,754,452	$ 1,731,607	$ 14,804,243	$ 15,139,568	$ 16,558,695	$ 16,871,175

Additional information on the City's capital assets can be found in Note 5 of this report.

CAPITAL ASSETS AND DEBT ADMINISTRATION - (Continued)

Long-Term Debt

During the 2011 fiscal year, the City issued $3,580,000 in Certificate of Obligation Bonds in order to fund water and sewer improvements. The City retired $135,000 of the prior outstanding debt issue, the 2004 General Obligation Refunding Bonds. The amount that is outstanding at year-end totals $4,005,000. The City also retired $35,800 of the tax notes issued in 2008 for the purchase of the new City Hall. The amount outstanding on the tax notes total $160,900. The 2011 and 2004 bonds mature in 2031 and 2014, respectively, and the tax notes mature in 2015. In the 2010 fiscal year, the City was deeded certain water and sewer improvements that were constructed by a developer. The City has agreed to reimburse the developer certain costs that were incurred in the construction of the improvements. The net amount owed to the developer at year end was $1,200,948.

Additional information on the City's long-term debt can be found in Note 10.

ECONOMIC FACTORS AND NEXT YEAR'S BUDGETS AND RATES

The following factors were considered in preparing the City's budget for the 2011-2012 fiscal year.

The total sales tax payments received by the City from the State Comptroller in fiscal year 2011 totaled $452,682. This amount is an increase of $61,050 or 15.67% over the previous year, indicating a fairly stable pattern (growing pattern) in the retail economy.

The certified assessed taxable property valuations for the 2011 tax roll total $161,263,073 with a tax rate of $0.857080 per $100 valuation. The tax rate increased $0.04392 over last year. $0.82549 was allocated for maintenance and operations, and $0.03238 was allocated for interest and sinking (debt service). The projected total property tax due is $1,296,916 for the 2011 tax year. The certified assessed taxable property valuations were les than the 2010 values due to a decline in values in the Beachside Subdivision.

Of the $1,296,916 of projected 2011 property tax due, and using a 95% collection rate, $77,162 is projected to be collected from the newly annexed Beachside subdivision. Of the $77,162 projected collection, $57,872 would be payable to the developer of the Beachside subdivision as per the City's development agreement.

The development agreement provides that in exchange for the developer's financing and extending of the off site water and sewer lines to the development, the City agreed to reimburse 75% of collected tax revenue and tap fees generated from the development site until the total reimbursement amount equals the extension costs. The amount of $1,405,101 was agreed upon by the developer and the City for the extension of the water and sewer lines. As of the end of the fiscal year, $204,153 had been reimbursed leaving a balance of $1,200,948.

It is important to note that only taxes and fees actually collected will be subject to reimbursement and that funds reimbursed will only be generated from the development site.

At the time of adoption of the 2011-2012 fiscal year budget, completion of the issuance of approximately $3.5 million of certificates of obligation and the associated debt service was included in the budget. The proceeds of these certificates are to be used to finance the construction of a new water well, ground storage tank, water main replacements, water tower rehabilitation, and necessary improvements to the wastewater treatment plant.

The revenue needed to fund this debt is to be derived solely through increases in the water and sewer rates under a revised rate structure that encourages water conservation.

Requests for Information

This financial report is designed to provide a general overview of the City's finances for all those with an interest in the City's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Finance Office, 311 Henderson Avenue, Palacios, Texas 77465.

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Basic Financial Statements

CITY OF PALACIOS, TEXAS
STATEMENT OF NET ASSETS
September 30, 2011

	Primary Government			Component Unit
	Governmental Activities	Business-type Activities	Total	Palacios Economic Development Corporation
ASSETS				
Current assets				
Cash and cash equivalents	$ 210,913	$ 3,941,142	$ 4,152,055	$ 192,598
Receivables (net)	618,488	317,110	935,598	2,850
Internal balances	305,152	(305,152)	-	-
Due from other governments	132,082	-	132,082	27,988
Inventory	6,360	77,008	83,368	-
Total current assets	1,272,995	4,030,108	5,303,103	223,436
Noncurrent assets				
Capital assets				
Land and other assets not being depreciated	510,456	176,341	686,797	-
Buildings, improvements, and equipment (net)	1,243,996	14,627,902	15,871,898	-
Deferred expenses (net)	6,855	158,911	165,766	-
Total noncurrent assets	1,761,307	14,963,154	16,724,461	-
Total assets	3,034,302	18,993,262	22,027,564	223,436

	Primary Government			Component Unit
	Governmental Activities	Business-type Activities	Total	Palacios Economic Development Corporation
LIABILITIES				
Current liabilities				
Accounts payable	$ 159,019	$ 168,368	$ 327,387	$ 9,536
Accrued expenses	16,890	5,654	22,544	668
Accrued interest payable	-	110,320	110,320	-
Due to other governments	14,499	-	14,499	-
Customer meter deposits	-	110,945	110,945	-
Accrued compensated absences	21,375	6,328	27,703	665
Payable to developer	-	75,000	75,000	-
Current portion of long-term obligations	37,500	140,000	177,500	-
Total current liabilities	249,283	616,615	865,898	10,869
Noncurrent liabilities				
Noncurrent portion of long-term obligations	123,400	5,065,465	5,188,865	-
Total noncurrent liabilities	123,400	5,065,465	5,188,865	-
Total liabilities	372,683	5,682,080	6,054,763	10,869
NET ASSETS				
Invested in capital assets, net of related debt	1,593,552	12,739,751	14,333,303	-
Unrestricted net assets	1,068,067	571,431	1,639,498	212,567
Total net assets	$ 2,661,619	$ 13,311,182	$ 15,972,801	$ 212,567

The accompanying notes are an integral part of this statement.

CITY OF PALACIOS, TEXAS
STATEMENT OF ACTIVITIES
For the year ended September 30, 2011

Function/Programs	Expenses	Program Revenues: Charges for Services	Program Revenues: Operating Grants and Contributions	Program Revenues: Capital Grants and Contributions
Primary Government				
Governmental activities				
General government	$ 735,576	$ 33,490	$ 1,307	$ -
Public safety	1,175,658	63,268	-	-
Public works	438,010	571	51,920	116,455
Special services	152,721	-	-	-
Health and welfare	62,883	-	-	-
Interest on long-term debt	13,526	-	-	-
Total governmental activities	2,578,374	97,329	53,227	116,455
Business-type activities				
Water and sewer	2,270,627	2,241,745	-	115,110
Airport	82,762	60,584	-	-
Total business-type activities	2,353,389	2,302,329	-	115,110
Total primary government	$ 4,931,763	$ 2,399,658	$ 53,227	$ 231,565
Component Unit				
Palacios Economic Development Corporation	$ 142,062	$ -	$ -	$ -

General revenues:
- Taxes:
  - Property taxes, levied for general purposes
  - Property taxes, levied for debt service
  - Sales taxes
  - Franchise taxes
  - Other taxes and fees
- Unrestricted investment earnings
- Miscellaneous

Transfers

Total general revenues and transfers

Change in net assets

Net assets - beginning

Net assets - ending

The accompanying notes are an integral part of this statement.

Net (Expense) Revenue and Changes in Net Assets			Component Unit
Primary Government			
Governmental Activities	Business-type Activities	Total	Palacios Economic Development Corporation
$ (700,779)	$ -	$ (700,779)	$ -
(1,112,390)	-	(1,112,390)	-
(269,064)	-	(269,064)	-
(152,721)	-	(152,721)	-
(62,883)	-	(62,883)	-
(13,526)	-	(13,526)	-
(2,311,363)	-	(2,311,363)	-
-	86,228	86,228	-
-	(22,178)	(22,178)	-
-	64,050	64,050	-
(2,311,363)	64,050	(2,247,313)	-
-	-	-	(142,062)
1,204,891	-	1,204,891	-
44,601	-	44,601	-
452,682	-	452,682	151,441
149,710	-	149,710	-
23,420	-	23,420	-
955	3,028	3,983	598
180,437	42,840	223,277	11,401
577,280	(577,280)	-	-
2,633,976	(531,412)	2,102,564	163,440
322,613	(467,362)	(144,749)	21,378
2,339,006	13,778,544	16,117,550	191,189
$ 2,661,619	$ 13,311,182	$ 15,972,801	$ 212,567

CITY OF PALACIOS, TEXAS

BALANCE SHEET
GOVERNMENTAL FUNDS
September 30, 2011

	General	Other Governmental Funds	Total Governmental Funds
ASSETS			
Current assets			
Cash and cash equivalents	$ 97,484	$ 95,969	$ 193,453
Receivables (net)	512,379	106,109	618,488
Due from other governments	132,083	-	132,083
Due from other funds	380,278	4,210	384,488
Inventory	6,360	-	6,360
Total assets	1,128,584	206,288	1,334,872
LIABILITIES AND FUND BALANCES			
Liabilities			
Accounts payable	41,823	106,898	148,721
Accrued expenditures	16,890	-	16,890
Due to other funds	4,210	4,025	8,235
Due to other governments	9,864	4,635	14,499
Deferred revenue	494,819	3,673	498,492
Total liabilities	567,606	119,231	686,837
Fund balances			
Nonspendable	6,360	-	6,360
Restricted	-	87,057	87,057
Unassigned	554,618	-	554,618
Total fund balances	560,978	87,057	648,035
Total liabilities and fund balances	$ 1,128,584	$ 206,288	$ 1,334,872

The accompanying notes are an integral part of this statement.

CITY OF PALACIOS, TEXAS
RECONCILIATION OF TOTAL GOVERNMENTAL FUND BALANCE TO NET ASSETS OF GOVERNMENTAL ACTIVITIES
September 30, 2011

Total governmental fund balances		$ 648,035
Amounts reported for governmental activities in the statement of net assets are different because:		
The Internal Service Fund is used by the City to account for the costs of equipment owned by the City. The assets and liabilities of the Internal Service Fund are included in governmental activities in the statement of net assets.		45,937
Property taxes, fines and weedy lot receivables will be collected this year, but are not available soon enough to pay for the current period's expenditures, and therefore are deferred in the funds.		498,492
Capital assets used in governmental activities are reported as expenditures in governmental funds when purchased or constructed. The cost of these assets is $6,375,167 and the accumulated depreciation is $4,730,592.		1,644,575
Other noncurrent assets (for example, debt issuance costs) used in governmental activities are not financial resources, and therefore are not reported in governmental funds. The cost of these assets is $12,000 and the accumulated amortization is $5,145.		6,855
Long-term liabilities are not due and payable in the current period and therefore are not reported as liabilities in the funds. Long-term liabilities at year-end consist of:		
Tax notes payable	$ (160,900)	
Compensated absences	(21,375)	(182,275)
Net assets of governmental activities		$ 2,661,619

The accompanying notes are an integral part of this statement.

CITY OF PALACIOS, TEXAS

STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES
GOVERNMENTAL FUNDS
For the year ended September 30, 2011

	General	Other Governmental Funds	Total Governmental Funds
REVENUES			
Taxes	$ 1,855,338	$ 62,090	$ 1,917,428
Licenses and permits	15,310	-	15,310
Intergovernmental	1,307	118,375	119,682
Charges for services	18,751	-	18,751
Fines and forfeitures	58,357	3,266	61,623
Investment income	797	139	936
Miscellaneous	139,521	4,652	144,173
Total revenues	2,089,381	188,522	2,277,903
EXPENDITURES			
Current			
General government	636,139	27,000	663,139
Public safety	1,015,671	-	1,015,671
Public works	361,828	134,919	496,747
Special services	152,721	-	152,721
Health and welfare	48,587	-	48,587
Debt service			
Principal retirement	35,800	-	35,800
Interest and fiscal charges	11,811	-	11,811
Total expenditures	2,262,557	161,919	2,424,476
Excess (deficiency) of revenues over expenditures	(173,176)	26,603	(146,573)
OTHER FINANCING SOURCES (USES)			
Transfers in	422,280	-	422,280
Transfers out	(70,000)	(5,000)	(75,000)
Total other financing sources (uses)	352,280	(5,000)	347,280
Net change in fund balances	179,104	21,603	200,707
Fund balances at beginning of year	381,874	65,454	447,328
Fund balances at end of year	$ 560,978	$ 87,057	$ 648,035

The accompanying notes are an integral part of this statement.

CITY OF PALACIOS, TEXAS

RECONCILIATION OF THE GOVERNMENTAL FUNDS STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES TO THE STATEMENT OF ACTIVITIES

For the year ended September 30, 2011

Total net change in fund balances - governmental funds		$ 200,707
Amounts reported for governmental activities in the statement of activities are different because:		
The Internal Service Fund is used by the City to account for the costs of equipment owned by the City. The net loss of the Internal Service Fund is reported with governmental activities.		(33,211)
Current year capital outlays are expenditures in the fund financial statements, but they should be shown as increases in capital assets in the government-wide financial statements. The net effect of removing the 2010/2011 capital outlays is to increase net assets.		183,133
Depreciation is not recognized as an expense on the governmental funds since it does not require the use of current financial resources. The net effect of the current year's depreciation is to decrease net assets.		(108,107)
Current year proceeds and payments on long-term debt are other financing sources and expenditures in the fund financial statements, but they serve to increase or reduce long-term liabilities in the government-wide financial statements. In the current year, these amounts consist of:		
Note principal retirement		35,800
Because some property taxes will not be collected for several months after the City's fiscal year ends, they are not considered "available" revenues and are deferred in the governmental funds. Similarly, other revenues are not currently available at year-end and are not reported as revenue in the governmental funds.		45,785
Some items reported in the statement of activities do not require the use of current financial resources and therefore are not reported as expenditures in governmental funds. These activities consist of:		
Decrease in debt issue costs	$ (1,715)	
Decrease in compensated absences	221	(1,494)
Change in net assets of governmental activities		$ 322,613

The accompanying notes are an integral part of this statement.

CITY OF PALACIOS, TEXAS
STATEMENT OF NET ASSETS
PROPRIETARY FUNDS
September 30, 2011

	Business-type Activities			Governmental Activities- Internal Service Fund
	Water and Sewer	Airport	Total	
ASSETS				
Current assets				
Cash and cash equivalents	$ 3,837,366	$ 103,776	$ 3,941,142	$ 17,460
Receivables (net)	316,660	450	317,110	-
Due from other funds	4,025	-	4,025	-
Inventory	54,063	22,944	77,007	-
Total current assets	4,212,114	127,170	4,339,284	17,460
Noncurrent assets				
Land and other assets not being depreciated	176,341	-	176,341	-
Buildings, improvements, and equipment (net)	14,270,573	357,329	14,627,902	109,877
Deferred expenses (net)	158,911	-	158,911	-
Total noncurrent assets	14,605,825	357,329	14,963,154	109,877
Total assets	18,817,939	484,499	19,302,438	127,337
LIABILITIES				
Current liabilities				
Accounts payable	166,177	2,191	168,368	10,298
Accrued expenses	5,654	-	5,654	-
Due to other funds	275,643	33,533	309,176	71,102
Accrued interest payable	110,320	-	110,320	-
Customer meter deposits	110,945	-	110,945	-
Accrued compensated absences	6,328	-	6,328	-
Current portion of payable to developer	75,000	-	75,000	-
Current portion of general obligation bonds	140,000	-	140,000	-
Total current liabilities	890,067	35,724	925,791	81,400
Noncurrent liabilities				
General obligation bonds	285,000	-	285,000	-
Certificates of obligation	3,654,517	-	3,654,517	-
Payable to developer	1,125,948	-	1,125,948	-
Total noncurrent liabilities	5,065,465	-	5,065,465	-
Total liabilities	5,955,532	35,724	5,991,256	81,400
NET ASSETS				
Invested in capital assets, net of related debt	12,739,751	357,329	13,097,080	109,877
Unrestricted net assets	122,656	91,446	214,102	(63,940)
Total net assets	$ 12,862,407	$ 448,775	$ 13,311,182	$ 45,937

The accompanying notes are an integral part of this statement.

CITY OF PALACIOS, TEXAS
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN FUND NET ASSETS
PROPRIETARY FUNDS
For the year ended September 30, 2011

	Business-type Activities			Governmental Activities- Internal Service Fund
	Water and Sewer	Airport	Total	
OPERATING REVENUES				
Charges for services	$ 2,241,745	$ 29,969	$ 2,271,714	$ -
Rents	-	30,615	30,615	-
Total operating revenues	2,241,745	60,584	2,302,329	-
OPERATING EXPENSES				
Water system	663,556	-	663,556	-
Sanitary sewer system	292,580	-	292,580	-
Solid waste	613,394	-	613,394	-
Airport expenses	-	67,056	67,056	-
Miscellaneous	16,623	-	16,623	-
Equipment expenses	-	-	-	211,049
Depreciation and amortization	555,397	15,706	571,103	52,181
Total operating expenses	2,141,550	82,762	2,224,312	263,230
Operating income (loss) before nonoperating revenues (expenses) and contributions and transfers	100,195	(22,178)	78,017	(263,230)
NONOPERATING REVENUES (EXPENSES)				
Investment income	2,878	150	3,028	19
Connection fees	8,500	-	8,500	-
Miscellaneous income	10,634	69	10,703	-
Nonoperating lease income	-	23,637	23,637	-
Interest and fiscal charges	(129,077)	-	(129,077)	-
Total nonoperating revenues (expenses)	(107,065)	23,856	(83,209)	19
Income (loss) before contributions and transfers	(6,870)	1,678	(5,192)	(263,211)
Contributions and transfers				
Capital contributions	115,110	-	115,110	-
Transfers in	-	-	-	230,000
Transfers out	(522,500)	(54,780)	(577,280)	-
Total contributions and transfers	(407,390)	(54,780)	(462,170)	230,000
Change in net assets	(414,260)	(53,102)	(467,362)	(33,211)
Total net assets at beginning of year	13,276,667	501,877	13,778,544	79,148
Total net assets at end of year	$ 12,862,407	$ 448,775	$ 13,311,182	$ 45,937

The accompanying notes are an integral part of this statement.

CITY OF PALACIOS, TEXAS
STATEMENT OF CASH FLOWS
PROPRIETARY FUNDS
For the year ended September 30, 2011

	Business-type Activities			
	Water and Sewer	Airport	Total	Governmental Activities- Internal Service Fund
CASH FLOWS FROM OPERATING ACTIVITIES				
Cash received from customers	$ 2,164,987	$ 60,584	$ 2,225,571	$ -
Cash paid to suppliers for goods and services	(1,159,727)	(75,543)	(1,235,270)	(212,000)
Cash paid to employees for services	(356,946)	-	(356,946)	-
Net cash provided (used) by operating activities	648,314	(14,959)	633,355	(212,000)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES				
Transfers (to) from other funds	(522,500)	(54,780)	(577,280)	230,000
Borrowings (repayments) to other funds	164,602	33,533	198,135	(559)
Connection fees	8,500	-	8,500	-
Miscellaneous income (expense)	10,634	23,706	34,340	-
Increase (decrease) in customer meter deposits	2,865	-	2,865	-
Net cash provided (used) by noncapital financing activities	(335,899)	2,459	(333,440)	229,441
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES				
Acquisition and construction of capital assets	(116,156)	-	(116,156)	-
Increase in bond issue costs	(122,431)	-	(122,431)	-
Proceeds from issuance of debt	3,654,517	-	3,654,517	-
Principal paid on long-term debt	(185,017)	-	(185,017)	-
Interest paid	(20,265)	-	(20,265)	-
Net cash provided (used) by capital and related financing activities	3,210,648	-	3,210,648	-
CASH FLOWS FROM INVESTING ACTIVITIES				
Investment income	2,878	150	3,028	19
Net cash provided (used) by investing activities	2,878	150	3,028	19
Net increase (decrease) in cash and cash equivalents	3,525,941	(12,350)	3,513,591	17,460
Cash and cash equivalents at beginning of year	311,425	116,126	427,551	-
Cash and cash equivalents at end of year	$ 3,837,366	$ 103,776	$ 3,941,142	$ 17,460

CITY OF PALACIOS, TEXAS
STATEMENT OF CASH FLOWS
PROPRIETARY FUNDS
For the year ended September 30, 2011

	Business-type Activities			
	Water and Sewer	Airport	Total	Governmental Activities-Internal Service Fund
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES				
Operating income (loss)	$ 100,195	$ (22,178)	$ 78,017	$ (263,230)
Adjustments to reconcile operating income to net cash provided by operating activities				
Depreciation and amortization	555,397	15,706	571,103	52,181
Changes in assets and liabilities				
(Increase) decrease in accounts receivable	(76,758)	-	(76,758)	-
(Increase) decrease in inventory	(5,965)	1,705	(4,260)	-
Increase (decrease) in accounts payable	89,558	(10,192)	79,366	(951)
Increase (decrease) in accrued expenses	(11,789)	-	(11,789)	-
Increase (decrease) in compensated absences	(2,324)	-	(2,324)	-
Total adjustments	548,119	7,219	555,338	51,230
Net cash provided (used) by operating activities	$ 648,314	$ (14,959)	$ 633,355	$ (212,000)
Noncash capital and related financing activities				
Infrastructure improvements contributed by other funds	$ 115,110			

The accompanying notes are an integral part of this statement.

CITY OF PALACIOS, TEXAS
STATEMENT OF FIDUCIARY NET ASSETS
FIDUCIARY FUNDS
September 30, 2011

	Agency Fund
ASSETS	
Cash and cash equivalents	$ 210,581
Total assets	$ 210,581
LIABILITIES	
Liabilities	
Due to others	$ 210,581
Total liabilities	$ 210,581

The accompanying notes are an integral part of this statement.

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NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The City of Palacios, Texas (the "City") was incorporated in 1909. The voters of the City passed a referendum during the May 3, 2003, election to form a Charter Commission and to elect a board of commissioners to frame the new charter. The Commission presented the Charter to the City Council and was passed by the voters during the November 2, 2004, election. The passing of the Charter allowed the City to change from a Type A General Law City to a Home Rule City with a Council-Manager form of government. Other changes allowed the Mayor's position to vote on all items and required a sixth Council position to be created which was filled in the November 2, 2004, election. The City Manager is responsible for law enforcement, appointment and removal of department directors and employees, supervision and control of all City departments, and preparation of the annual budget. The Mayor presides at meetings of the City Council and is allowed to vote on all matters. The City provides the following services: public safety to include police, fire, and emergency medical services, highways and streets, water and wastewater, sanitation, recreation, public improvements, planning and zoning, and general administration.

A. Reporting Entity

In evaluating how to define the government, for financial reporting purposes, the City's management has considered all potential component units. The decision to include a potential component unit in the reporting entity was made by applying the criteria set forth in the Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity,* and as amended by GASB Statement No. 39, *Determining Whether Certain Organizations are Component Units.* Under these guidelines, the reporting entity consists of the primary government (all funds of the City), organizations for which the primary government is financially accountable, organizations for which the primary government is not financially accountable, organizations that raise and hold economic resources for the direct benefit of the primary government, and any other organization for which the nature and significance of their relationship with the primary government is such that exclusion could cause the City's financial statements to be misleading or incomplete. Entities other than the primary government that are included in the primary government's financial statements are called component units. The component unit discussed in this note is included in the City's financial statements because of the significance of its financial relationship with the City.

B. Component Unit

The component unit is reported in a separate column to emphasize that it is legally separate from the City. The component unit column is made of the following:

The Palacios Economic Development Corporation (the "Corporation") was created for the purpose of benefiting and accomplishing public purposes of the City by promoting, encouraging, and enhancing the creation of jobs in the City. This is to be achieved through assistance in the retention of existing businesses and industries and the attraction of new businesses and industries and aid in their development and growth. Each Director of the Corporation is appointed to office by the City Council. Once appointed, they may be removed from office at will by a majority vote of the Council members. Under guidelines established by GASB, this fact makes the Corporation financially accountable to the City. Because other necessary conditions are also met, the Corporation has been included as a discretely presented component unit of the City in the accompanying financial statements. The Corporation uses the same fiscal year as the City and is presented as a governmental fund type. No other organizations met the necessary criteria to be considered component units of the City for the year ending September 30, 2011.

The component unit is discretely presented in the financial statements. Complete financial statements of the component unit can be obtained from Palacios City Hall, P.O. Box 845, Palacios, Texas 77465.

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - (Continued)

C. Government-wide and Fund Financial Statements

The government-wide financial statements (i.e., the statement of net assets and the statement of changes in net assets) report information on all nonfiduciary activities of the City and its component unit. For the most part, the effect of interfund activity has been removed from these statements. Governmental activities, which normally are supported by taxes, and intergovernmental revenues are reported separately from business-type activities, which rely to a significant extent on fees and charges for support. Likewise, the primary government is reported separately from its legally separate component units.

The statement of activities demonstrates the degree to which the direct expenses of a given function or segment are offset by program revenues. Direct expenses are those that are clearly identifiable with a specific function or segment. Program revenues include: 1) charges to customers or applicants who purchase, use, or directly benefit from goods, services, or privileges provided by a given function or segment and 2) grants and contributions that are restricted to meeting the operational or capital requirements of a particular function or segment. Taxes and other items not properly included among program revenues are reported instead as general revenues.

Separate financial statements are provided for governmental funds and proprietary funds. Major individual governmental funds and major individual enterprise funds are reported as separate columns in the fund financial statements.

D. Measurement Focus, Basis of Accounting, and Financial Statement Presentation

The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting, as are the proprietary fund financial statements. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Property taxes are recognized as revenues in the year for which they are levied. Grants and similar items are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met.

Governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the City considers revenues to be available if they are collected within 60 days of the end of the current fiscal period. Expenditures generally are recorded when a liability is incurred, as under accrual accounting. However, debt service expenditures, as well as expenditures related to compensated absences and claims and judgments, are recorded only when payment is due.

Property taxes, franchise taxes, fines, and interest associated with the current fiscal period are all considered to be susceptible to accrual and so have been recognized as revenues of the current fiscal period. All other revenue items are considered to be measurable and available only when cash is received by the City.

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - (Continued)

D. Measurement Focus, Basis of Accounting, and Financial Statement Presentation - (Continued)

The City reports the following major governmental fund:

The General Fund is the City's primary operating fund. It accounts for all financial resources of the general government, except those required to be accounted for in another fund.

The City reports the following major proprietary funds:

Enterprise Funds are used to account for operations: 1) that are financed and operated in a manner similar to private business enterprises - where the intent of the governing body is that the costs (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges, or 2) where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

The Water and Sewer Fund, an enterprise fund, accounts for the activities of the City related to its sewage treatment plant and water distribution system.

The Airport Fund, an enterprise fund, accounts for the operation of the City's Airport.

Additionally, the City reports the following fund types:

The Special Revenue Funds account and report proceeds of specific revenue sources that are restricted or committed to expenditure for specific purposes other than debt service or capital projects.

The Debt Service Fund is used to account for and report financial resources that are restricted, committed or assigned to expenditure for general government debt principal and interest.

The Internal Service Fund is used to account for the City's equipment related expenses. Such operations are operated in a manner similar to private business enterprises, where the intent of the City is that the costs of providing equipment services to the various City departments on a continuing basis will be financed or recovered primarily through user charges to the departments.

The Agency Fund accounts for the collection of a deposit from a real estate developer. The funds will be used to pay for certain infrastructure improvements related to the development. The City has no ownership on these assets and are therefore excluded from the government-wide statements.

Private-sector standards of accounting and financial reporting issued prior to December 1, 1989, generally are followed in both the government-wide and proprietary fund financial statements to the extent that those standards do not conflict with or contradict guidance of GASB. Governments also have the option of following subsequent private-sector guidance for their business-type activities and enterprise funds, subject to this same limitation. The City has elected not to follow subsequent private-sector guidance.

As a general rule the effect of interfund activity has been eliminated from the government-wide financial statements. Exceptions to this general rule are charges between various functions of the City. Elimination of these charges would distort the direct costs and program revenues reported for the various functions concerned.

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - (Continued)

D. Measurement Focus, Basis of Accounting, and Financial Statement Presentation - (Continued)

Amounts reported as program revenues include: 1) charges to customers or applicants for goods, services, or privileges provided, 2) operating grants and contributions, and 3) capital grants and contributions, including special assessments. Internally dedicated resources are reported as general revenues rather than as program revenues. Likewise, general revenues include all taxes.

Proprietary funds distinguish operating revenues and expenses from non-operating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. The principal operating revenues of the City's enterprise funds and the Internal Service Fund are charges to customers for sales and services. The Water and Sewer Fund also recognizes as operating revenue the portion of tap fees intended to recover the cost of connecting new customers to the system. Operating expenses for enterprise funds and internal service funds include the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

When both restricted and unrestricted resources are available for use, it is the City's policy to use restricted resources first and then unrestricted resources as they are needed.

E. Budgets and Budgetary Accounting

The City follows these procedures in establishing the budgetary data reflected in the financial statements.

1. Prior to August 1, the City Manager submits to the City Council a proposed operating budget for the fiscal year commencing the following October 1. The operating budget includes proposed expenditures and the means of financing them.

2. Public hearings are conducted at City Hall to obtain taxpayer comments.

3. Prior to October 1, the budget is legally enacted through passage of an ordinance.

4. The City Manager is authorized to transfer budgeted amounts between line items within a department; however, any revisions that alter the total expenditures of any department must be approved by the City Council.

5. Formal budgetary integration was employed as a management control device during the year. The Debt Service Fund is not budgeted because effective budgetary control is alternatively achieved through general obligation bond indenture provisions.

6. All appropriations lapse at year-end. The City does not employ the use of encumbrances in its budgetary accounting.

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - (Continued)

F. Deposits and Investments

The City's cash and cash equivalents are considered to be cash on hand, demand deposits, and short-term investments with original maturities of three months or less from the date of acquisition.

The City may invest its excess funds in any instruments authorized by the Public Funds Investment Act of Texas. Investments authorized under this Act include, but are not limited to, the following: Obligations of the United States or its agencies and instrumentalities; direct obligations of the State of Texas or its agencies and instrumentalities; collateralized mortgage obligations directly issued by a federal agency or instrumentality of the United States, the underlying security for which is guaranteed by an agency or instrumentality of the United States; other obligations, the principal and interest of which are unconditionally guaranteed or insured by, or backed by the full faith and credit of, the State of Texas or the United States or their respective agencies and instrumentalities; certificates of deposit issued by a state or financial institution domiciled in the State of Texas which is guaranteed or insured by the Federal Deposit Insurance Corporation (FDIC) or otherwise secured; and certain repurchase agreements.

As of September 30, 2011, the City has adopted a formal investment policy.

G. Receivables and Payables

Activity between funds that are representative of lending/borrowing arrangements outstanding at the end of the fiscal year are referred to as "due to/from other funds". Any residual balances outstanding between the governmental activities and business-type activities are reported in the government-wide financial statements as "internal balances".

All trade and property tax receivables are shown net of an allowance for uncollectibles. Property tax receivables include unpaid property taxes at year-end along with penalties and interest assessed on these unpaid taxes. The allowance on the unpaid property taxes is equal to 10% of the outstanding property taxes and the allowance on the penalties and interest is equal to 75% of the assessed amount.

H. Inventory and Prepaid Items

Inventory is valued at the lower of cost (first-in, first-out) or market. Estimated cost is used when actual cost figures are not available. The costs of governmental fund-type inventories are recorded as expenditures when purchased rather than when consumed.

Certain payments to vendors reflect costs applicable to future accounting periods. These payments are reported as deferred expenditures (governmental funds) or prepaid expenses (proprietary funds) in the fund financial statements and as deferred expenditures/expenses in the government-wide financial statements.

I. Capital Assets

Capital assets, which include property, plant and equipment, are reported in the applicable governmental or business-type activities columns in the government-wide statement of net assets. The City defines capital assets as assets with an initial, individual cost of more than $5,000 and an estimated useful life in excess of one year. Such assets are recorded at historical cost or estimated historical cost if purchased or constructed. Donated capital assets are recorded at estimated fair market value at the date of donation.

The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend asset lives are not capitalized.

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - (Continued)

I. Capital Assets - (Continued)

Major outlays for capital assets and improvements are capitalized as projects are constructed. Interest is capitalized on capital assets of business-type activities when acquired with tax-exempt debt. The amount of interest to be capitalized is calculated by offsetting interest expense incurred during the period of construction until completion of the project with interest earned on invested proceeds over the same period.

Property, plant, and equipment of the primary government is depreciated using the straight-line method over the following estimated useful lives:

Assets	Years
Buildings	50
Improvements other than buildings	40
Water and wastewater distribution system	40
Machinery and equipment	2-20
Office equipment and fixtures	3-15

J. Compensated Absences

The City allows ten days sick leave per year for each full-time employee and further allows each employee to accumulate up to ninety days of sick leave. Upon termination, there is no provision to pay the employee for accumulated sick days.

All full-time employees are given ten days vacation each year up to ten years of service and fifteen days per year thereafter. Employees may carryover a maximum of 80 hours of unused vacation time to the next year. Employees are paid for unused vacation time upon termination.

City employees can also earn compensatory time off for overtime hours worked. Employees have the option of either being paid for overtime work or taking additional time off at the rate of one and one-half hours in compensatory time for each hour of overtime worked. Most City personnel may accrue a maximum of 80 hours of compensatory time. Earned but unused compensatory time is paid to employees upon termination.

All compensated absences pay is accrued when incurred in the government-wide and proprietary fund financial statements. A liability for these amounts is reported in governmental funds only if they have matured, for example, as a result of employee resignation and retirement.

K. Long-Term Obligations

In the government-wide financial statements, and in proprietary fund types in the fund financial statements, long-term debt and other long-term obligations are reported as liabilities in the applicable governmental activities, business-type activities, or proprietary fund type statement of net assets. Bond premiums and discounts, as well as issuance costs, are deferred and amortized over the life of the bonds using the effective interest method. Bonds payable are reported net of the applicable bond premium or discount. Bond issuance costs are reported as deferred charges and amortized over the term of the related debt. Losses or gains on refunding are capitalized and amortized over the shorter life of the new issuance or the life on existing debt.

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - (Continued)

K. Long-Term Obligations - (Continued)

In the fund financial statements, governmental fund types recognize bond premiums and discounts, as well as bond issuance costs, during the current period. The face amount of debt issued is reported as other financing sources. Premiums received on debt issuances are reported as other financing sources while discounts on debt issuances are reported as other financing uses. Issuance costs, whether or not withheld from the actual debt proceeds received, are reported as debt service expenditures.

L. Fund Equity

GASB Statement No. 54, "*Fund Balance Reporting and Governmental Fund Type Definitions*," (the "Statement") was issued in February 2009. This Statement eliminates the requirement to report governmental fund balances as reserved, unreserved, or designated. It replaces those categories with five possible classifications of governmental fund balances - nonspendable, restricted, committed, assigned, and unassigned. This Statement also redefines the governmental funds for clarity and to be consistent with these new fund balance classifications. The provisions of this Statement are effective for periods beginning after June 15, 2010. The City did not adopt a new fund balance policy in accordance with GASB Statement No. 54 during fiscal year 2011. This Statement did not have an impact on the City's functions, financial position or results of operations.

M. Use of Estimates

The preparation of the government-wide and fund financial statements in conformity with generally accepted accounting principles requires the City to make estimates and assessments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of financial statements and the reported amounts of revenues and expenditures during the reporting period. Accordingly, actual results could differ from those estimates.

NOTE 2: STEWARDSHIP, COMPLIANCE, AND ACCOUNTABILITY

Budgetary Compliance

There were six departments that expenditures exceeded the amount appropriated during the fiscal year 2010-2011.

General Fund - Department	Final Budget	Actual	Negative Variance
Legal	$ 12,000	$ 12,873	$ (873)
Library	30,000	36,250	(6,250)
Police	969,350	989,784	(20,434)
Fire	17,320	25,887	(8,567)
Park maintenance	139,300	151,996	(11,884)
Recycling center	40,030	41,550	(1,520)

These expenditures were funded by an available fund balance in the General Fund.

NOTE 3: DEPOSITS AND INVESTMENTS

The City's funds are required to be deposited and invested under the terms of a depository contract pursuant to the Texas Public Funds Investment Act. The depository bank pledges securities which comply with state law and these securities are held for safekeeping and trust with the City's and the depository bank's agent bank. The pledge of approved securities is waived only to the extent of the depository bank's dollar amount of FDIC insurance.

As of September 30, 2011, the City had the following investments:

Investment Type	Amortized Cost	Weighted Average Maturity (Days)
Public Funds Investment Pool		
TexPool	$ 3,888,367	44

The pool operates in a manner consistent with the Securities and Exchange Commission's (SEC) Rule 2(a)(7) of the Investment Company Act of 1940 but is not registered with the SEC as an investment company. Instead, the regulatory oversight for the pool is the State of Texas. The pool uses amortized cost rather than market value to report net assets to compute share prices. Accordingly, the fair value of the position in these pools is the same as the value of the shares in each pool.

Interest Rate Risk

In accordance with the City's investment policy, the City manages its exposure to declines in fair values by limiting the weighted average maturity of its investment portfolio to less than one year from the time of purchase. TexPool's weighted average maturity cannot exceed 60 days.

Credit Risk

The investment pool operates in full compliance with the Public Funds Investment Act. TexPool is rated AAAm by Standard & Poor's.

Concentration of Credit Risk

The City's investment policy requires that the investment portfolio shall be diversified in terms of investment instruments, maturity scheduling, and financial institutions to reduce the risk of loss resulting from over concentration of assets in a specific class of investments, specific maturity, or specific user. At year-end, the City was not exposed to concentration of credit risk.

Custodial Credit Risk - Deposits

In the case of deposits, this is the risk that in the event of a bank failure, the City's deposits may not be returned to it. The City's investment policy requires that deposits at financial institutions be insured by the FDIC and/or collateralized by securities pledged to the City by the depository in an amount equal to at least 110% of the carrying value of deposits held. During the fiscal year and at year-end, all deposits held in the depository bank were fully collateralized and therefore the City was not exposed to custodial credit risk.

Custodial Credit Risk - Investments

For an investment, this is the risk that, in the event of the failure of the counterparty, the City will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. All of the City's investments are invested in TexPool and it has no custodial credit risk.

NOTE 4: RECEIVABLES

Receivables at September 30, 2011, consist of the following:

	General	Water and Sewer	Airport Fund	Nonmajor Funds	Total
Gross receivables:					
Accounts	$ 48,810	$ 486,656	$ 450	$ -	$ 535,916
Ad valorem taxes	658,389	-	-	9,619	668,008
Franchise taxes	18,558	-	-	-	18,558
Fines	70,908	-	-	-	70,908
Other	-	800	-	96,898	97,698
Total gross receivables	796,665	487,456	450	106,517	1,391,088
Less: allowances	284,286	170,796	-	408	455,490
Total net receivables	$ 512,379	$ 316,660	$ 450	$ 106,109	$ 935,598

The City's governmental funds report deferred revenue in connection with receivables for revenues that are not considered to be available to liquidate liabilities of the current period. The governmental funds also defer revenue recognition in connection with resources that have been received, but not yet earned. At the end of the current fiscal year, the various components of deferred revenue and unearned revenue reported in the governmental funds were as follows:

	Unavailable	Unearned	Total
General Fund			
Ad valorem taxes	$ 413,279	$ -	$ 413,279
Fines	68,422	-	68,422
Weedy lot mowing	13,118	-	13,118
Debt Service Fund			
Ad valorem taxes	3,673	-	3,673
	$ 498,492	$ -	$ 498,492

The City's property taxes are levied annually on October 1st on the basis of the Appraisal District's assessed values as of January 1st of that calendar year. Appraised values are established by the Appraisal District at market value and assessed at 100% of appraised value. The City's property taxes are billed and collected by the Palacios Independent School District and are due and payable on January 31st. Such taxes are applicable to the fiscal year in which they are levied and become delinquent with an enforceable lien on the property on February 1st of the subsequent calendar year.

For the current year, the City levied property taxes of $0.81316 per $100 of assessed valuation. $0.782470 was allocated for maintenance and operations, and $0.03069 was allocated for interest and sinking (debt service). The resulting adjusted total tax levy was $1,293,549 on the total adjusted taxable valuation of $165,982,971 for the 2010 tax roll.

NOTE 5: CAPITAL ASSETS

The City's capital assets activity for the year ended September 30, 2011, was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Governmental activities				
Capital assets, not being depreciated				
Land	$ 357,286	$ -	$ -	$ 357,286
Construction in progress	-	153,170	-	153,170
Total capital assets not being depreciated	357,286	153,170	-	510,456
Capital assets, being depreciated				
Machinery and equipment	1,848,442	13,467	-	1,861,909
Land structured facilities	4,205,968	16,496	-	4,222,464
Buildings	863,826	-	-	863,826
Total capital assets being depreciated	6,918,236	29,963	-	6,948,199
Less accumulated depreciation for				
Machinery and equipment	1,432,087	101,462	-	1,533,549
Land structured facilities	3,859,212	42,524	-	3,901,736
Buildings	252,616	16,302	-	268,918
Total accumulated depreciation	5,543,915	160,288	-	5,704,203
Total capital assets being depreciated, net	1,374,321	(130,325)	-	1,243,996
Governmental activities capital assets, net	$ 1,731,607	$ 22,845	$ -	$ 1,754,452
Business-type activities				
Capital assets, not being depreciated				
Land	$ 7,373	$ -	$ -	$ 7,373
Construction in progress	94,354	168,968	94,354	168,968
Total capital assets not being depreciated	101,727	168,968	94,354	176,341
Capital assets, being depreciated				
Machinery and equipment	611,171	13,467	-	624,638
Buildings and improvements	3,471,118	-	-	3,471,118
Water and sewer system	16,912,539	48,830	-	16,961,369
Land structured facilities	1,190,407	94,354	-	1,284,761
Total capital assets being depreciated	22,185,235	156,651	-	22,341,886
Less accumulated depreciation for				
Machinery and equipment	607,718	3,571	-	611,289
Buildings and improvements	2,805,142	90,444	-	2,895,586
Water works system	2,909,631	448,366	-	3,357,997
Land structured facilities	824,903	24,209	-	849,112
Total accumulated depreciation	7,147,394	566,590	-	7,713,984
Total capital assets being depreciated, net	15,037,841	(409,939)	-	14,627,902
Business-type activities capital assets, net	$15,139,568	$ (240,971)	$ 94,354	$14,804,243

NOTE 5: CAPITAL ASSETS - (Continued)

Depreciation expense was charged to functions/programs of the City as follows:

Governmental activities	
General government	$ 62,444
Public safety	42,738
Public works	46,328
Public health	8,778
Total depreciation expense - governmental activities	$ 160,288
Business-type activities	
Utilities	$ 550,885
Airport	15,706
Total depreciation expense - business-type activities	$ 566,591

The Palacios Economic Development Corporation has $12,799 of capital assets at September 30, 2011, consisting of various equipment and leasehold improvements. These assets were fully depreciated at September 30, 2011.

NOTE 6: EMPLOYEES' RETIREMENT PLAN

Plan Description

The City provides pension benefits for all of its eligible employees through a nontraditional, joint contributory, hybrid defined benefit plan in the statewide Texas Municipal Retirement System (TMRS), an agent multiple-employer public employee retirement system. The plan provisions that have been adopted by the City are within the options available in the governing state statutes of TMRS.

TMRS issues a publicly available comprehensive annual financial report that includes financial statements and required supplementary information (RSI) for TMRS; the report also provides detailed explanations of the contributions, benefits and actuarial methods and assumptions used by TMRS. This report may be obtained by writing to TMRS, P.O. Box 149153, Austin, Texas 78714-9153 or by calling 800-924-8677; in addition, the report is available on TMRS' website at www.TMRS.com. The plan provisions are adopted by the governing body of the City, within the options available in the state statutes governing TMRS. Plan provisions for the City were as follows:

	Plan Year 2010	Plan Year 2011
Employee deposit rate	5.0%	5.0%
Matching ratio (city to employee)	1.5 to 1	1.5 to 1
Years required for vesting	5	5
Service retirement eligibility (expressed as age/years of service)	60/5, 0/20	60/5, 0/20
Updated service credit	100% repeating transfers	100% repeating transfers
Annuity increase (to retirees)	70% of CPI repeating	70% of CPI repeating

NOTE 6: EMPLOYEES' RETIREMENT PLAN - (Continued)

Contributions

Under the state law governing TMRS, the contribution rate for each city is determined annually by the actuary, using the Projected Unit Credit actuarial cost method. This rate consists of the normal cost contribution rate and the prior service cost contribution rate, which is calculated to be a level percent of payroll from year to year. The normal cost contribution rate finances the portion of an active member's projected benefit allocated annually; the prior service contribution rate amortizes the unfunded (overfunded) actuarial liability (asset) over the applicable period for that city. Both the normal cost and prior service contribution rates include recognition of the projected impact of annually repeating benefits, such as Updated Service Credits and Annuity Increases.

The City contributes to the TMRS Plan at an actuarially determined rate. Both the employees and the City make contributions monthly. Since the City needs to know its contribution rate in advance for budgetary purposes, there is a one-year delay between the actuarial valuation that serves as the basis for the rate and the calendar year when the rate goes into effect. The annual pension cost and net pension obligation (asset) are as follows:

Contributions Required and Contributions Made

Year Ended September 30	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation
2011	$ 105,366	100%	$ -
2010	90,083	100%	-
2009	80,812	100%	-

The required contribution rates for fiscal year 2011 were determined as part of the December 31, 2008 and 2009 actuarial valuations. Additional information as of the latest actuarial valuation, December 31, 2010, also follows:

Actuarial Valuation Information

	12/31/10 Restructured	12/31/10 Prior to Restructuring	12/31/09	12/31/08
Actuarial cost method	projected unit credit	projected unit credit	projected unit credit	projected unit credit
Amortization method	level percent of payroll	level percent of payroll	level percent of payroll	level percent of payroll
GASB 25 equivalent single amortization period	27.1 years; closed period	27.0 years; closed period	28.1 years; closed period	29.0 years; closed period
Amortization period for new gains/losses	30 years	30 years	30 years	30 years
Asset valuation method	10-year smoothed market	10-year smoothed market	10-year smoothed market	amortized cost
Investment rate of return *	7.0%	7.5%	7.5%	7.5%
Projected salary increases *	varies by age and service	varies by age and service	varies by age and service	varies by age and service
*Includes Inflation at	3.0%	3.0%	3.0%	3.0%
Cost of living adjustments	2.1%	2.1%	2.1%	2.1%

NOTE 6: EMPLOYEES' RETIREMENT PLAN - (Continued)

Funded Status and Funding Progress

In June 2011, SB 350 was enacted by the Texas Legislature, resulting in a restructure of the TMRS funds. This legislation provided for the actuarial valuation to be completed, as if restructuring had occurred on December 31, 2010. In addition, the actuarial assumptions were updated for the new fund structure, based on an actuarial experience study that was adopted by the TMRS Board at their May 2011 meeting (the review compared actual to expected experience for the four-year period of January 1, 2006 through December 31, 2009). For a complete description of the combined impact of the legislation and new actuarial assumptions, including the effects on TMRS's city rates and funding ratios, please see the December 31, 2010 TMRS Comprehensive Annual Financial Report (CAFR).

The funded status as of December 31, 2010, under the two separate actuarial valuations is presented as follows:

Schedule of Funding Progress

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Annual Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
12/31/10[2]	$ 2,263,123	$ 2,903,314	$ 640,191	77.95%	$ 1,278,418	50.08%
12/31/10[1]	1,530,234	2,251,452	721,218	67.97%	1,278,418	56.41%

[1] Actuarial valuation performed under the original fund structure
[2] Actuarial valuation performed under the new fund structure

Actuarial valuations involve estimates of the value of reported amounts and assumptions about the probability of events far into the future. Actuarially determined amounts are subject to continual revision as actual results are compared to past expectations and new estimates are made about the future.

Actuarial calculations are based on the benefits provided under the terms of the substantive plan in effect at the time of each valuation, and reflect a long-term perspective. Consistent with that perspective, actuarial methods and assumptions used include techniques that are designed to reduce short-term volatility in actuarial accrued liabilities and the actuarial value of assets. The schedule of funding progress, presented as Required Supplementary Information following the notes to the financial statements, presents multi-year trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liability of benefits.

NOTE 7: TEXAS EMERGENCY SERVICES RETIREMENT SYSTEM

Plan Description

The Fire Fighters' Pension Commissioner (FFPC) is the administrator of the Texas Emergency Services Retirement System (TESRS), a cost-sharing multiple employer pension system established and administered by the State of Texas to provide pension benefits for emergency services personnel who serve without significant monetary remuneration. TESRS is considered a component unit of the State of Texas financial reporting entity and is included in the State's financial reports as a pension trust fund. The Office of the FFPC issues a publicly available annual financial report that includes financial statements and required supplementary information (RSI). This report may be obtained by writing to FFPC, 920 Colorado Street, 11th Floor, Austin, Texas 78701 in addition, the report is available on FFPC's website at www.ffpc.state.tx.us. At August 31, 2010, there were 199 members of fire or emergency services departments participating in TESRS. Eligible participants include volunteer emergency services personnel who are members in good standing of a participating department.

NOTE 7: TEXAS EMERGENCY SERVICES RETIREMENT SYSTEM - (Continued)

Plan Description - (Continued)

At August 31, 2010, TESRS membership consisted of:

Retirees and beneficiaries currently receiving benefits	2,167
Terminated participants entitled to benefits but not yet receiving them	2,106
Active participants (vested and nonvested)	4,371
	8,644

Senate Bill 411, 65th Legislature, Regular Session (1977), created TESRS and established the applicable benefit provisions. The 79th Legislature, Regular Session (2005) recodified the provision and gave the TESRS Board of Trustees authority to establish vesting requirements, contribution levels, benefit formulas, and eligibility requirements by board rule. The benefit provisions include retirement benefits as well as death and disability benefits. Members are 50% vested after the tenth year of service, with the vesting percent increasing 10% for each of the next five years of service so that a member becomes 100% vested with 15 years of service.

Upon reaching age 55, each vested member may retire and receive a monthly pension equal to his vested percent multiplied by six times the governing body's average monthly contribution over the member's years of qualified service. For years of service in excess of 15 years, this monthly benefit is increased at the rate of 6.2% compounded annually.

On and off duty death benefits and on duty disability benefits are dependent on whether or not the member was engaged in the performance of duties at the time of death or disability. Death benefits include a lump sum amount and continuing monthly payments to a member's surviving spouse and dependent children.

Funding Policy

Contribution provisions were originally established by Senate Bill 411, 65th Legislature, Regular Session (1977) and were amended by board rule in 2006. No contributions are required by individual members of participating departments. The governing bodies of participating departments are required to contribute at least the minimum prescribed amount per month for each active member and may contribute more. Additional contributions may be made by a governing body to pay for granting credit for service before the department began participating in TESRS (prior service). The State may also be required to make annual contributions up to a limited amount to make TESRS actuarially sound.

NOTE 7: TEXAS EMERGENCY SERVICES RETIREMENT SYSTEM - (Continued)

Annual Required Contributions

The contribution requirement per active emergency services personnel member per month is not actuarially determined. Rather, the minimum contribution provisions were set by board rule. For the fiscal year ending August 31, 2010, total contributions (dues and prior services) of $2,875,103 were paid into TESRS by the political subdivisions served by the member volunteer emergency services personnel. The State did not appropriate any maximum state contribution for the fiscal years ending August 31, 2010 and 2011. Total contributions made were equal to the contributions required by the state statute and were equal to the contributions required based on the revised August 31, 2008, actuarial valuation.

The purpose of the biennial actuarial valuation is to test the adequacy of the financing arrangement to determine if it is adequate to pay the benefits that are promised. The actuarial valuation as of August 31, 2010, revealed the adequacy of the expected contributions from the political subdivisions (dues and prior service contributions) together with the actual state appropriations for the fiscal year ending August 31, 2010, ($502,941 to help pay for the TESRS's administrative expenses) and with the assumed continuation of legislative appropriations of 1) the maximum state contribution amount in future years for up to 30 years as is necessary for the TESRS to have a 30-year amortization period, and 2) approximately $500,000 each year to help pay for the TESRS's administrative expenses. Expected contributions for the fiscal year ending August 31, 2011 are less than the contributions required because of the lag in time between an actuarial valuation that shows the need for maximum state contribution amounts and the appropriations process.

Without the expected future annual contributions from the state, TESRS would have an inadequate contribution arrangement.

Three-Year Trend Information - State-wide

Fiscal Year Ending August 31	Annual Required Contributions	Actual Contributions	Percentage Contributed
2010	$ 2,875,103[3]	$ 2,875,103	100%
2009	2,698,271[3]	2,698,271	100%
2008	3,160,764[2]	11,239,339[1]	356%

[1] Includes a state contribution of $8,800,000.
[2] Based on the August 31, 2006, actuarial valuation.
[3] Based on the August 31, 2008, actuarial valuation.

State contributions to the City's plan for the fiscal year 2011 has been deemed insignificant to the financial statements. Therefore, no amounts have been recognized as revenues and expenditures during the period.

Three-Year Trend Information - City of Palacios, Texas

Year Ended September 30	Annual Required Contributions (ARC)	Percentage Contributed	Net Obligation
2011	$ 13,336	100%	$ -
2010	11,444	100%	-
2009	11,695	100%	-

NOTE 8: SUPPLEMENTAL DEATH BENEFIT PLAN

The City also participates in the cost sharing multiple-employer defined benefit group-term life insurance plan operated by TMRS known as the Supplemental Death Benefits Fund (SDBF). The City elected, by ordinance, to provide group-term life insurance coverage to both current and retired employees. The City may terminate coverage under and discontinue participation in the SDBF by adopting an ordinance before November 1st of any year to be effective the following January 1st.

The death benefit for active employees provides a lump-sum payment approximately equal to the employee's annual salary (calculated based on the employee's actual earnings, for the 12-month period preceding the month of death); retired employees are insured for $7,500; this coverage is an "other postemployment benefit", or OPEB.

NOTE 9: RISK MANAGEMENT

The City is exposed to various risks of loss encompassed in the areas of general liabilities, workers' compensation claims, and employee health related expenses. The City has purchased general liability and workers' compensation insurance to cover potential losses in those areas. The City has entered into interlocal agreements with the Texas Municipal League Intergovernmental Risk Pool for general liability and workers' compensation coverage. Through the payment of contributions to the Texas Municipal League Intergovernmental Risk Pool, the City has transferred these risks to the pool. The City has not retained any risks other than the deductible and is covered up to the limits of coverage after the deductible. Settlements of claims did not exceed insurance coverage for any of the past three years.

The City has also entered into an interlocal agreement with the Texas Municipal League Group Benefits Risk Pool for health insurance for its employees. The City pays the health care premiums for City employees. Employees have the option of paying dependent coverage via payroll deductions. The City has no liability for any claims incurred by participants in this plan.

NOTE 10: LONG-TERM DEBT

A. Changes in Long-Term Liabilities

Long-term liability activity for the year ended September 30, 2011, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Due Within One Year
Governmental activities					
Tax notes	$ 196,700	$ -	$ 35,800	$ 160,900	$ 37,500
Compensated absences	21,596	33,406	33,627	21,375	21,375
Total governmental activity long-term liabilities	$ 218,296	$ 33,406	$ 69,427	$ 182,275	$ 58,875
Business-type activities					
General obligation bonds	$ 560,000	$ -	$ 135,000	$ 425,000	$ 140,000
Certificates of obligation	-	3,580,000	-	3,580,000	-
Issuance premium	-	74,517	-	74,517	-
Compensated absences	8,652	12,273	14,597	6,328	6,328
Payable to developer	1,250,965	-	50,017	1,200,948	75,000
Total business-type activity long-term liabilities	$ 1,819,617	$ 3,666,790	$ 199,614	$ 5,286,793	$ 221,328

NOTE 10: LONG-TERM DEBT - (Continued)

B. General Obligation Refunding Bonds and Certificates of Obligation

The City issued general obligation refunding bonds in October 2004 to retire the remaining balance of the 1994 general obligation bonds. General obligation refunding bonds are direct obligations and pledge the full faith and credit of the City. The bonds have been issued for both governmental and business-type activities. There is still $440,000 of bonds outstanding of the original 1994 issue.

The City issued certificates of obligation in March 2011 to provide for water and sewer capital improvements.

General obligation refunding bonds and certificates of obligation currently outstanding are as follows:

	Term	Interest Rate	Original Amount
Series 2004	2004 - 2014	1.50% - 3.80%	$ 1,545,000
Series 2011	2011 - 2031	2.00% - 4.375%	$ 3,580,000

Annual debt service requirements to maturity for general obligation refunding bonds and certificates of obligation are as follows:

	Business-type Activities		
Year	Principal	Interest	Total
2012	$ 140,000	$ 200,138	$ 340,138
2013	140,000	140,070	280,070
2014	325,000	134,655	459,655
2015	180,000	128,300	308,300
2016	185,000	123,800	308,800
2017-2021	1,025,000	528,225	1,553,225
2022-2026	905,000	344,100	1,249,100
2027-2031	1,105,000	145,500	1,250,500
	$ 4,005,000	$ 1,744,788	$ 5,749,788

C. Tax Notes

The City also issued tax notes to provide funds for the acquisition of major capital facilities payable from the proceeds of an annual ad valorem tax. The tax notes have been issued for governmental type activities.

	Term	Interest Rate	Original Amount
Tax Notes, Series 2008	2008 - 2018	3.25% - 4.25%	$ 264,000

NOTE 10: LONG-TERM DEBT - (Continued)

C. Tax Notes - (Continued)

Annual debt service requirements to maturity for tax notes are as follows:

	Governmental Activities		
Year	Principal	Interest	Total
2012	$ 37,500	$ 6,549	$ 44,049
2013	39,200	5,105	44,305
2014	41,100	3,537	44,637
2015	43,100	1,832	44,932
	$ 160,900	$ 17,023	$ 177,923

D. Payable to Developer

In 2005, the City entered into a reimbursement contract with a land development company that was anticipating purchasing property for the development of a residential subdivision. The amount of the reimbursement was based on the amount spent on certain infrastructure improvements incurred in the development of the subdivision. The total expense incurred by the developer amounted to $1,405,101. The City has agreed to pay the developer 75% of the property taxes collected based on a formula agreed upon by the parties. The City will continue to pay the developer on an annual basis until 100% of the $1,405,101 has been repaid. The City has made payments of $66,982, $87,154, and $50,017 for the 2009, 2010, and 2011 fiscal years, respectively. The City has recorded the net liability of $1,200,948 in the accompanying financial statements. There is no predetermined repayment schedule since the amounts paid annually depend on the amount of taxes collected on certain properties. The accompanying financial statements reflect an estimated current portion of $75,000.

NOTE 11: INTERFUND RECEIVABLES, PAYABLES, AND TRANSFERS

A. Interfund Receivables and Payables

At times during the fiscal year the various funds of the City were involved in transactions that created interfund receivable and payable balances. These transactions related to such things as the purchase of goods by one fund on behalf of another and the receipt of revenue in one fund that belongs to or is designated for another fund. Interfund receivable and payable balances as of September 30, 2011, were as follows:

Receivable Fund	Payable Fund	Amount
General	Airport	$ 33,533
	Equipment	71,102
	Water and Sewer	275,643
Nonmajor Governmental	General	4,210
Water and Sewer	Nonmajor Governmental	4,025
		$ 388,513

NOTE 11: INTERFUND RECEIVABLES, PAYABLES, AND TRANSFERS - (Continued)

B. Interfund Transfers

Each year various funds of the City transfer funds to other funds. The most significant of these are the planned transfers from the City's enterprise funds to specified governmental funds. These transfers are intended to provide the necessary resources to meet the operating and debt service obligations of the receiving funds. During the current fiscal year, transfers between funds consisted of the following:

	Transfers In		
Transfers Out	General Fund	Equipment Fund	Total
General	$ -	$ 70,000	$ 70,000
Nonmajor Governmental	5,000	-	5,000
Water and Sewer	382,500	140,000	522,500
Airport	34,780	20,000	54,780
	$ 422,280	$ 230,000	$ 652,280

NOTE 12: COMMITMENTS AND CONTINGENCIES

Operating Leases

Commitments under operating lease agreements for equipment provide for minimum future rental payments as of September 30, 2011, as follows:

Year Ended September 30	
2012	$ 1,967
Total minimum rentals	$ 1,967

Total rental expense incurred for the year was $11,799.

Grant Programs

The City participates in numerous state and federal grant programs, which are governed by various rules and regulations of the grantor agencies. Costs charged to the respective grant programs are subject to audit and adjustment by the grantor agencies; therefore, to the extent that the City has not complied with rules and regulations governing the grants, refunds of any money received may be required and the collectibility of any related receivable at September 30, 2011, may be impaired. In the opinion of the City, there are no significant contingent liabilities relating to compliance with the rules and regulations governing the respective grants; therefore, no provision has been recorded in the accompanying combined financial statements for such contingencies.

NOTE 13: FUND BALANCES

The following is a detail of the governmental fund balances as of September 30, 2011:

	Governmental Fund Balances			
	Nonspendable	Restricted	Unassigned	Total
General				
Inventory	$ 6,360	$ -	$ -	$ 6,360
Unassigned	-	-	554,618	554,618
Nonmajor Governmental				
Retirement of long-term debt	-	44,601	-	44,601
Municipal court	-	22,482	-	22,482
State and federal grant programs	-	12,429	-	12,429
Public safety	-	6,283	-	6,283
Tourism	-	1,262	-	1,262
	$ 6,360	$ 87,057	$ 554,618	$ 648,035

Required Supplementary Information

CITY OF PALACIOS, TEXAS
MAJOR GOVERNMENTAL FUNDS - GENERAL FUND
SCHEDULE OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE
BUDGET (GAAP BASIS) AND ACTUAL
For the year ended September 30, 2011

	Original Budget	Final Budget	Actual	Variance Positive (Negative)
REVENUES				
Taxes				
Ad valorem taxes	$ 1,242,670	$ 1,242,670	$ 1,247,015	$ 4,345
Other taxes	539,950	539,950	608,323	68,373
Licenses and permits	14,000	14,000	15,310	1,310
Intergovernmental	1,200	1,200	1,307	107
Charges for services	700	700	18,751	18,051
Fines and forfeitures	65,000	65,000	58,357	(6,643)
Investment income	1,500	1,500	797	(703)
Miscellaneous	99,810	99,810	139,521	39,711
Total revenues	1,964,830	1,964,830	2,089,381	124,551
EXPENDITURES				
Current				
General government	625,760	625,760	636,139	(10,379)
Public safety	986,670	986,670	1,015,671	(29,001)
Public works	430,360	430,360	361,828	68,532
Special services	165,720	165,720	152,721	12,999
Health and welfare	47,880	47,880	48,587	(707)
Debt service	43,700	43,700	47,611	(3,911)
Total expenditures	2,300,090	2,300,090	2,262,557	37,533
Excess (deficiency) of revenues over expenditures	(335,260)	(335,260)	(173,176)	162,084
OTHER FINANCING SOURCES (USES)				
Transfers in	423,390	423,390	422,280	(1,110)
Transfers out	(70,000)	(70,000)	(70,000)	-
Total other financing sources (uses)	353,390	353,390	352,280	(1,110)
Net change in fund balance	18,130	18,130	179,104	160,974
Fund balance at beginning of year	381,874	381,874	381,874	-
Fund balance at end of year	$ 400,004	$ 400,004	$ 560,978	$ 160,974

The accompanying notes to required supplementary information are an integral part of this schedule.

TEXAS MUNICIPAL RETIREMENT SYSTEM

The schedule of funding progress presents multi-year trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liability of benefits.

Schedule of Funding Progress

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Annual Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
12/31/10[2]	$ 2,263,123	$ 2,903,314	$ 640,191	77.95%	$ 1,278,418	50.08%
12/31/10[1]	1,530,234	2,251,452	721,218	67.97%	1,278,418	56.41%
12/31/09	1,330,616	2,005,641	675,025	66,.34%	1,236,169	54.60%
12/31/08	1,299,339	1,958,870	659,531	66.33%	1,220,172	54.10%
12/31/07	1,246,830	1,814,959	568,129	68.70%	1,075,651	52.80%
12/31/06	1,777,426	1,479,549	297,877	83.24%	981,787	30.77%
12/31/05	1,056,926	1,334,192	277,266	79.22%	928,603	29.85%
12/31/04	1,135,211	1,336,721	201,510	84.90%	881,498	22.90%
12/31/03	1,083,899	1,222,272	138,373	88.70%	909,694	15.20%
12/31/02	966,794	1,096,054	129,260	88.20%	863,664	14.97%
12/31/01	918,339	1,030,753	112,414	89.10%	668,544	16.81%

[1]Actuarial valuation performed under the original fund structure
[2]Actuarial valuation performed under the new fund structure

TEXAS EMERGENCY SERVICES RETIREMENT SYSTEM

	Actuarial Valuation Information	
	8/31/08	8/31/10
Actuarial cost method	entry age	entry age
Amortization method	level dollar, open	level dollar, open
Amortization period	6 years	30 years
Asset valuation method	market value smoothed by a 5-year deferred recognition method with a 90% - 110% corridor on market value	market value smoothed by a 5-year deferred recognition method with a 80% - 120% corridor on market value
Investment rate of return *	8.00%, net of expenses	7.75%, net of expenses
Projected salary increases	n/a	n/a
* Includes inflation at	3.50%	3.50%
Cost of living adjustment	none	none

TEXAS EMERGENCY SERVICES RETIREMENT SYSTEM - (Continued)

Schedule of Funding Progress

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability[1] (AAL) - Entry Age (b)	Unfunded AAL (UAAL) (b)-(a)	Funded Ratio (a/b)	Total Members Covered (c)	UAAL per Member Covered (b-a)/(c)
8/31/2006	$ 42,268,305	$ 58,082,828	$ 15,814,523	72.8%	8,061	$ 1,962
8/31/2008[2]	60,987,157	64,227,341	3,240,184	95.0%	8,254	393
8/31/2010[3]	64,113,803	79,953,215	15,839,412	80.2%	8,708	1,819

[1] The actuarial accrued liability is based upon the entry age actuarial cost method.
[2] Changes in actuarial assumptions and methods, as well as benefit and contribution provisions, were first reflected in this valuation.
[3] Changes in actuarial assumptions were reflected in this valuation.

Three-Year Trend Information - State-wide

Fiscal Year Ending August 31	Annual Required Contributions	Actual Contributions	Percentage Contributed
2010	$ 2,875,103[3]	$ 2,875,103	100%
2009	2,698,271[3]	2,698,271	100%
2008	3,160,764[2]	11,239,339[1]	356%

[1] Includes a state contribution of $8,800,000.
[2] Based on the August 31, 2006, actuarial valuation.
[3] Based on the August 31, 2008, actuarial valuation.

State contributions to the City's plan for the fiscal year 2011 has been deemed insignificant to the financial statements. Therefore, no amounts have been recognized as revenues and expenditures during the period.

Three-Year Trend Information - City of Palacios, Texas

Year Ended September 30	Annual Required Contributions (ARC)	Percentage Contributed	Net Obligation
2011	$ 13,336	100%	$ -
2010	11,444	100%	-
2009	11,695	100%	-

NOTE 1: BUDGETARY BASIS OF ACCOUNTING

The City annually adopts budgets that are prepared using the modified accrual basis of accounting, which is consistent with generally accepted accounting principles.

NOTE 2: BUDGETARY LEGAL COMPLIANCE

For the year ended September 30, 2011 the City complied with budgetary restrictions at all departmental levels except the following. The following table details these variances:

General Fund - Department	Final Budget	Actual	Negative Variance
Legal	$ 12,000	$ 12,873	$ (873)
Library	30,000	36,250	(6,250)
Police	969,350	989,784	(20,434)
Fire	17,320	25,887	(8,567)
Park maintenance	139,300	151,184	(11,884)
Recycling center	40,030	41,550	(1,520)

Combining and Individual Fund Statements and Schedules

CITY OF PALACIOS, TEXAS
NONMAJOR GOVERNMENTAL FUNDS
COMBINING BALANCE SHEET
September 30, 2011

	Special Revenue Funds			
	Police Seized Drug	Hotel Motel Tax	TCDP Sewer Project	Pavilion Restoration Fund
ASSETS				
Cash and cash equivalents	$ 4,635	$ 5,724	$ -	$ 3,185
Receivables (net)				
Taxes	-	5,538	-	-
Other	-	-	21,808	-
Due from other funds	-	-	4,025	-
Total assets	$ 4,635	$ 11,262	$ 25,833	$ 3,185
LIABILITIES AND FUND BALANCES				
Liabilities				
Accounts payable	$ -	$ 10,000	$ 21,808	$ -
Due to other funds	-	-	4,025	-
Deferred revenue	-	-	-	-
Due to other governments	4,635	-	-	-
Total liabilities	4,635	10,000	25,833	-
Fund balances				
Restricted				
Public safety	-	-	-	-
Tourism	-	1,262	-	-
State and federal grant programs	-	-	-	3,185
Municipal court	-	-	-	-
Debt service	-	-	-	-
Total fund balances	-	1,262	-	3,185
Total liabilities and fund balances	$ 4,635	$ 11,262	$ 25,833	$ 3,185

Special Revenue Funds						
TDHCA Home Program	Safe School Sidewalk	Court Technology	Court Security	Forfeiture Funds	Judicial Efficiency	Safe School Bridge
$ -	$ -	$ 13,101	$ 9,381	$ 5,285	$ 998	$ 9,244
-	-	-	-	-	-	-
1,920	73,170	-	-	-	-	-
-	-	-	-	-	-	-
$ 1,920	$ 73,170	$ 13,101	$ 9,381	$ 5,285	$ 998	$ 9,244
$ 1,920	$ 73,170	$ -	$ -	$ -	$ -	$ -
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
1,920	73,170	-	-	-	-	-
-	-	-	-	5,285	998	-
-	-	-	-	-	-	-
-	-	-	-	-	-	9,244
-	-	13,101	9,381	-	-	-
-	-	-	-	-	-	-
-	-	13,101	9,381	5,285	998	9,244
$ 1,920	$ 73,170	$ 13,101	$ 9,381	$ 5,285	$ 998	$ 9,244

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CITY OF PALACIOS, TEXAS
NONMAJOR GOVERNMENTAL FUNDS
COMBINING BALANCE SHEET
September 30, 2011

	Debt Service Fund	Total
ASSETS		
Cash and cash equivalents	$ 44,416	$ 95,969
Receivables (net)		
Taxes	3,673	9,211
Other	-	96,898
Due from other funds	185	4,210
Total assets	$ 48,274	$ 206,288
LIABILITIES AND FUND BALANCES		
Liabilities		
Accounts payable	$ -	$ 106,898
Due to other funds	-	4,025
Deferred revenue	3,673	3,673
Due to other governments	-	4,635
Total liabilities	3,673	119,231
Fund balances		
Restricted		
Public safety	-	6,283
Tourism	-	1,262
State and federal grant programs	-	12,429
Municipal court	-	22,482
Debt service	44,601	44,601
Total fund balances	44,601	87,057
Total liabilities and fund balances	$ 48,274	$ 206,288

(concluded)

CITY OF PALACIOS, TEXAS

NONMAJOR GOVERNMENTAL FUNDS

COMBINING STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES

For the year ended September 30, 2011

	Special Revenue Funds			
	Police Seized Drug	Hotel Motel Tax	TCDP Sewer Project	Pavilion Restoration Fund
REVENUES				
Taxes				
Hotel - motel tax	$ -	$ 17,489	$ -	$ -
Ad valorem taxes	-	-	-	-
Court fees	-	-	-	-
Intergovernmental	-	-	43,285	-
Investment income				
Interest	-	34	-	-
Miscellaneous	878	1,000	190	-
Total revenues	878	18,523	43,475	-
EXPENDITURES				
Current				
General government				
Promotional expense	-	27,000	-	-
Public works	-	-	43,285	-
Total expenditures	-	27,000	43,285	-
Excess (deficiency) of revenues over expenditures	878	(8,477)	190	-
OTHER FINANCING SOURCES (USES)				
Transfers in (out)	(266)	(5,000)	-	-
Total other financing sources (uses)	(266)	(5,000)	-	-
Net change in fund balances	612	(13,477)	190	-
Fund balances at beginning of year	(612)	14,739	(190)	3,185
Fund balances at end of year	$ -	$ 1,262	$ -	$ 3,185

Special Revenue Funds						
TDHCA Home Program	Safe School Sidewalk	Court Technology	Court Security	Forfeiture Funds	Judicial Efficiency	Safe School Bridge
$ -	$ -	$ -	$ -	$ -	$ -	$ -
-	-	-	-	-	-	-
-	-	1,821	1,366	-	79	-
1,920	73,170	-	-	-	-	-
-	-	25	23	-	-	57
-	-	-	-	-	-	2,584
1,920	73,170	1,846	1,389	-	79	2,641
-	-	-	-	-	-	-
1,920	73,170	-	-	-	-	16,544
1,920	73,170	-	-	-	-	16,544
-	-	1,846	1,389	-	79	(13,903)
-	-	-	-	266	-	-
-	-	-	-	266	-	-
-	-	1,846	1,389	266	79	(13,903)
-	-	11,255	7,992	5,019	919	23,147
$ -	$ -	$ 13,101	$ 9,381	$ 5,285	$ 998	$ 9,244

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CITY OF PALACIOS, TEXAS
NONMAJOR GOVERNMENTAL FUNDS
COMBINING STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES
For the year ended September 30, 2011

	Debt Service Fund	Total
REVENUES		
Taxes		
Hotel - motel tax	$ -	$ 17,489
Ad valorem taxes	44,601	44,601
Court fees	-	3,266
Intergovernmental	-	118,375
Investment income		
Interest	-	139
Miscellaneous	-	4,652
Total revenues	44,601	188,522
EXPENDITURES		
Current		
General government		
Promotional expense	-	27,000
Public works	-	134,919
Total expenditures	-	161,919
Excess (deficiency) of revenues over expenditures	44,601	26,603
OTHER FINANCING SOURCES (USES)		
Transfers in (out)	-	(5,000)
Total other financing sources (uses)	-	(5,000)
Net change in fund balances	44,601	21,603
Fund balances at beginning of year	-	65,454
Fund balances at end of year	$ 44,601	$ 87,057

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GENERAL FUND

The General Fund is a constitutional fund and is utilized to account for all City revenues and expenditures except those which are required to be classed in other constitutional funds and such other funds that are presented separately to facilitate proper accountability.

CITY OF PALACIOS, TEXAS

MAJOR GOVERNMENTAL FUNDS - GENERAL FUND
BALANCE SHEET
September 30, 2011
With comparative totals for September 30, 2010

	2011	2010
ASSETS		
Cash and cash equivalents	$ 97,484	$ 190,301
Receivables (net)		
Accounts	26,820	24,224
Taxes	414,651	374,903
Fines	70,908	67,050
Due from other governments	132,083	83,861
Due from other funds	380,278	189,335
Inventory	6,360	14,059
Total assets	$ 1,128,584	$ 943,733
LIABILITIES AND FUND BALANCES		
Liabilities		
Accounts payable	$ 41,823	$ 67,656
Accrued expenses	16,890	32,053
Due to other funds	4,210	4,025
Due to other governments	9,864	5,418
Deferred revenue	494,819	452,707
Total liabilities	567,606	561,859
Fund balances		
Nonspendable	6,360	14,059
Unassigned	554,618	367,815
Total fund balances	560,978	381,874
Total liabilities and fund balances	$ 1,128,584	$ 943,733

CITY OF PALACIOS, TEXAS
MAJOR GOVERNMENTAL FUNDS - GENERAL FUND
SCHEDULE OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE
BUDGET (GAAP BASIS) AND ACTUAL
For the year ended September 30, 2011
With comparative totals for the year ended September 30, 2010

	2011			2010
	Final Budget	Actual	Variance Positive (Negative)	Actual
REVENUES				
Ad valorem taxes				
Current and delinquent taxes	$ 1,198,670	$ 1,204,891	$ 6,221	$ 1,149,908
Penalty and interest	32,000	41,463	9,463	46,949
Tax certificates, other fees	12,000	661	(11,339)	11,510
Total ad valorem taxes	1,242,670	1,247,015	4,345	1,208,367
Other taxes				
Sales tax	256,500	301,788	45,288	261,088
Property tax reduction sales tax	128,250	150,894	22,644	130,544
Franchise tax	146,000	149,710	3,710	146,694
Bingo tax	2,900	1,507	(1,393)	2,933
Mixed beverage tax	6,300	4,424	(1,876)	5,036
Total other taxes	539,950	608,323	68,373	546,295
Licenses and permits				
Building and moving permits	12,000	13,495	1,495	13,132
Dog licenses	2,000	1,815	(185)	2,795
Total licenses and permits	14,000	15,310	1,310	15,927
Intergovernmental				
Grant proceeds	1,200	1,307	107	1,250
Charges for services				
Weedy lot mowing	700	571	(129)	1,942
Economic development	-	18,180	18,180	-
Total charges for services	700	18,751	18,051	1,942
Fines and forfeitures				
Fines and court costs	65,000	58,357	(6,643)	72,722
Investment income				
Interest	1,500	797	(703)	2,070
Miscellaneous				
Insurance reimbursement	16,400	20,955	4,555	30,644
Maintenance contract	50,000	50,000	-	50,000
Other	33,410	68,566	35,156	68,356
Total miscellaneous	99,810	139,521	39,711	149,000
Total revenues	1,964,830	2,089,381	124,551	1,997,573

(continued)

CITY OF PALACIOS, TEXAS

MAJOR GOVERNMENTAL FUNDS - GENERAL FUND
SCHEDULE OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE
BUDGET (GAAP BASIS) AND ACTUAL
For the year ended September 30, 2011
With comparative totals for the year ended September 30, 2010

	2011			2010
	Final Budget	Actual	Variance Positive (Negative)	Actual
EXPENDITURES				
General government				
Mayor and city council				
Salaries and wages	$ 10,200	$ 9,400	$ 800	$ 10,100
Office supplies	1,500	1,596	(96)	1,419
Special services	3,620	3,400	220	537
Travel, training, and dues	3,700	3,987	(287)	2,302
Social security tax	790	876	(86)	868
Employee benefits	40	35	5	30
Capital outlay	-	7,759	(7,759)	-
Total mayor and city council	19,850	27,053	556	15,256
Elections				
Office supplies	1,150	99	1,051	1,161
Special services	780	-	780	767
Total elections	1,930	99	1,831	1,928
Administrative				
Salaries and wages	286,620	280,135	6,485	267,250
Office supplies	10,500	10,201	299	9,344
Maintenance - office equipment	13,280	12,530	750	17,404
Maintenance - buildings	1,100	865	235	1,150
Telephone	7,700	7,102	598	7,197
Electricity	10,300	5,689	4,611	8,856
Gas	300	273	27	256
Professional fees	12,980	10,537	2,443	12,884
Special services	34,140	44,116	(9,976)	49,971
Travel, training, and dues	8,300	6,944	1,356	7,259
Social security tax	21,930	22,220	(290)	20,472
Employee benefits	72,850	75,804	(2,954)	71,407
Capital outlay	2,220	4,250	(2,030)	11,685
Total administrative	482,220	480,666	1,554	485,135
Legal				
Special services	12,000	12,873	(873)	12,589

(continued)

CITY OF PALACIOS, TEXAS
MAJOR GOVERNMENTAL FUNDS - GENERAL FUND
SCHEDULE OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE
BUDGET (GAAP BASIS) AND ACTUAL
For the year ended September 30, 2011
With comparative totals for the year ended September 30, 2010

	2011			2010
	Final Budget	Actual	Variance Positive (Negative)	Actual
EXPENDITURES - (CONTINUED)				
General government - (continued)				
Corporation court				
Salaries and wages	$ 57,990	$ 57,282	$ 708	$ 52,425
Office supplies	300	226	74	239
Maintenance - office equipment	3,680	3,600	80	3,400
Telephone	600	559	41	579
Special services	970	778	192	174
Travel, training, and dues	1,500	1,075	425	255
Social security tax	4,440	4,549	(109)	4,036
Employee benefits	9,170	9,482	(312)	8,876
Capital outlay	1,110	1,647	(537)	2,614
Total corporation court	79,760	79,198	562	72,598
Library				
Special services	30,000	36,250	(6,250)	29,000
Total general government	625,760	636,139	(10,379)	616,506
Public safety				
Police department				
Salaries and wages	620,950	693,263	(72,313)	686,830
Minor tools	2,400	3,217	(817)	2,378
Office supplies	6,300	4,850	1,450	6,682
Clothing	4,500	3,472	1,028	4,628
Maintenance - buildings	800	1,020	(220)	1,014
Maintenance - radios/radar	500	-	500	281
Maintenance - office equipment	13,900	16,099	(2,199)	15,257
Telephone, electricity, and gas	16,980	16,724	256	18,401
Special services	11,820	18,418	(6,598)	12,726
Travel, training, and dues	8,000	6,115	1,885	5,316
Support of prisoners	700	508	192	530
Social security tax	47,510	55,301	(7,791)	52,986
Employee benefits	176,570	158,384	18,186	167,557
Capital outlay	58,420	12,413	46,007	17,212
Total police department	969,350	989,784	(20,434)	991,798

(continued)

CITY OF PALACIOS, TEXAS
MAJOR GOVERNMENTAL FUNDS - GENERAL FUND
SCHEDULE OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE
BUDGET (GAAP BASIS) AND ACTUAL
For the year ended September 30, 2011
With comparative totals for the year ended September 30, 2010

	2011			2010
	Final Budget	Actual	Variance Positive (Negative)	Actual
EXPENDITURES - (CONTINUED)				
Public safety - (continued)				
Fire department				
Supplies	$ 500	$ 245	$ 255	$ -
Chemicals	500	-	500	-
Maintenance - equipment	200	-	200	-
Maintenance - buildings	100	-	100	-
Maintenance - radios	300	-	300	-
Telephone	1,100	1,152	(52)	1,104
Electricity	2,200	1,254	946	1,871
Gas	200	211	(11)	191
Travel, training, and dues	1,000	-	1,000	-
Special services	9,220	13,186	(3,966)	11,444
Employee benefits	500	492	8	426
Capital outlay	1,500	9,347	(7,847)	1,833
Total fire department	17,320	25,887	(8,567)	16,869
Total public safety	986,670	1,015,671	(29,001)	1,008,667
Public works				
Park maintenance				
Tools and supplies	6,000	12,160	(6,160)	7,773
Chemicals	1,000	-	1,000	-
Reconstruction materials	5,000	-	5,000	-
Electricity	32,000	21,644	10,356	27,527
Special services	95,300	115,996	(20,696)	110,559
Capital outlay	-	1,384	(1,384)	-
Total park maintenance	139,300	151,184	(11,884)	145,859

(continued)

CITY OF PALACIOS, TEXAS
MAJOR GOVERNMENTAL FUNDS - GENERAL FUND
SCHEDULE OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE
BUDGET (GAAP BASIS) AND ACTUAL
For the year ended September 30, 2011
With comparative totals for the year ended September 30, 2010

	2011			2010
	Final Budget	Actual	Variance Positive (Negative)	Actual
EXPENDITURES - (CONTINUED)				
Public works - (continued)				
Streets				
Salaries and wages	$ 32,250	$ -	$ 32,250	$ 22,767
Tools and supplies	7,000	10,927	(3,927)	6,362
Chemicals	3,000	-	3,000	4,313
Clothing	400	-	400	123
Maintenance - radios	100	-	100	-
Reconstruction materials	10,000	39,544	(29,544)	53,346
Pipe and culverts	10,000	7,821	2,179	11,327
Electricity	80,000	45,482	34,518	80,012
Special services	12,900	7,809	5,091	21,403
Social security tax	2,620	-	2,620	1,742
Employee benefits	13,790	5,594	8,196	13,371
Capital outlay	119,000	93,467	25,533	91,703
Total streets	291,060	210,644	80,416	306,469
Total public works	430,360	361,828	68,532	452,328
Health and welfare				
Animal control				
Supplies	1,800	3,942	(2,142)	4,407
Telephone	700	929	(229)	612
Electricity	3,600	1,112	2,488	2,793
Special services	550	1,042	(492)	2,233
Travel, training, and dues	200	12	188	346
Capital outlay	1,000	-	1,000	-
Total animal control	7,850	7,037	813	10,391
Recycling center				
Salaries and wages	22,500	23,506	(1,006)	22,937
Tools and supplies	20	1,720	(1,700)	1,856
Telephone	750	757	(7)	847
Electricity	1,700	941	759	1,692
Special services	2,800	1,869	931	2,818
Travel, training, and dues	600	933	(333)	127
Social security tax	1,630	1,817	(187)	1,723
Employee benefits	10,030	10,007	23	9,502
Total recycling center	40,030	41,550	(1,520)	41,502
Total health and welfare	47,880	48,587	(707)	51,893

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CITY OF PALACIOS, TEXAS
MAJOR GOVERNMENTAL FUNDS - GENERAL FUND
SCHEDULE OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE
BUDGET (GAAP BASIS) AND ACTUAL
For the year ended September 30, 2011
With comparative totals for the year ended September 30, 2010

	2011			2010
	Final Budget	Actual	Variance Positive (Negative)	Actual
EXPENDITURES - (CONTINUED)				
Special services				
Unemployment	$ 5,000	$ 21,377	$ (16,377)	$ 8,704
Note principal	35,800	35,800	-	34,100
Note interest	7,900	11,811	(3,911)	9,085
Hospital assistance	10,000	10,000	-	10,000
Development agreement rebate	84,890	50,017	34,873	87,154
Insurance and bonds	55,830	70,037	(14,207)	70,738
Community improvements	10,000	1,290	8,710	4,254
Total special services	209,420	200,332	9,088	224,035
Total expenditures	2,300,090	2,262,557	37,533	2,353,429
Excess (deficiency) of revenues over expenditures	(335,260)	(173,176)	162,084	(355,856)
OTHER FINANCING SOURCES (USES)				
Transfers in	423,390	422,280	(1,110)	457,893
Transfers out	(70,000)	(70,000)	-	(41,569)
Total other financing sources (uses)	353,390	352,280	(1,110)	416,324
Net change in fund balance	18,130	179,104	160,974	60,468
Fund balance at beginning of year	381,874	381,874	-	321,406
Fund balance at end of year	$ 400,004	$ 560,978	$ 160,974	$ 381,874

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ENTERPRISE FUNDS

Enterprise funds account for the acquisition, operations and maintenance of the City's facilities and services which are entirely or predominantly supported by user charges or those for which the City has decided that periodic determination of the revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes. All activities necessary to provide services are accounted for in these funds, including, but not limited to, administration, operations, and maintenance. Debt service amounts are also included.

Water and Sewer Fund - Records transactions relative to the provision of water and wastewater services to the residents of the City.

Airport Fund - Records transactions relative to the operation of the City's Airport.

CITY OF PALACIOS, TEXAS
MAJOR ENTERPRISE FUND - WATER AND SEWER FUND
STATEMENT OF NET ASSETS
September 30, 2011
With comparative totals for September 30, 2010

	2011	2010
ASSETS		
Current assets		
Cash and cash equivalents	$ 3,837,366	$ 311,425
Receivables		
Accounts	486,656	379,050
Other	800	410
Allowance for uncollectible accounts	(170,796)	(139,558)
Due from other funds	4,025	10,658
Inventory	54,063	48,098
Total current assets	4,212,114	610,083
Noncurrent assets		
Capital assets		
Office equipment and furniture	47,715	47,715
Machinery and equipment	496,031	482,563
Service delivery system	16,961,369	16,912,539
Buildings and fixtures	3,404,639	3,404,639
Land structured facilities	760,184	760,184
Total capital assets	21,669,938	21,607,640
Accumulated depreciation	(7,399,365)	(6,848,480)
Subtotal	14,270,573	14,759,160
Land	7,373	7,373
Construction in progress	168,968	-
Net capital assets	14,446,914	14,766,533
Deferred expenses (net)	158,911	40,992
Total noncurrent capital assets	14,605,825	14,807,525
Total assets	18,817,939	15,417,608
LIABILITIES		
Current liabilities		
Accounts payable	166,177	76,619
Accrued expenses	5,654	17,443
Due to other funds	275,643	117,674
Accrued interest payable	110,320	1,508
Customer meter deposits	110,945	108,080
Accrued compensated absences	6,328	8,652
Current portion of payable to developer	75,000	75,000
Current portion of general obligation bonds	140,000	135,000
Total current liabilities	890,067	539,976
Noncurrent liabilities		
General obligation bonds	285,000	425,000
Certificates of obligation	3,654,517	-
Payable to developer	1,125,948	1,175,965
Total noncurrent liabilities	5,065,465	1,600,965
Total liabilities	5,955,532	2,140,941
NET ASSETS		
Invested in capital assets, net of related debt	12,739,751	12,995,052
Unrestricted net assets	122,656	281,615
Total net assets	$ 12,862,407	$ 13,276,667

CITY OF PALACIOS, TEXAS

MAJOR ENTERPRISE FUND - WATER AND SEWER FUND
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN FUND NET ASSETS
For the year ended September 30, 2011
With comparative totals for the year ended September 30, 2010

	2011	2010
OPERATING REVENUES		
Charges for services	$ 2,241,745	$ 1,874,969
OPERATING EXPENSES		
Water system	663,556	539,276
Sanitary sewer system	292,580	228,379
Solid waste	613,394	545,720
Miscellaneous	16,623	16,211
Depreciation	550,885	459,638
Amortization	4,512	4,512
Total operating expenses	2,141,550	1,793,736
Operating income (loss) before nonoperating revenues (expenses) and contributions and transfers	100,195	81,233
NONOPERATING REVENUES (EXPENSES)		
Investment income		
Interest	2,878	1,895
Connection fees	8,500	4,800
Miscellaneous income (expense)	10,634	8,705
Interest and fiscal charges	(129,077)	(26,926)
Total nonoperating revenues (expenses)	(107,065)	(11,526)
Income (loss) before contributions and transfers	(6,870)	69,707
Contributions and transfers		
Capital contributions	115,110	9,399,438
Transfers out	(522,500)	(483,680)
Total contributions and transfers	(407,390)	8,915,758
Change in net assets	(414,260)	8,985,465
Total net assets at beginning of year	13,276,667	4,291,202
Total net assets at end of year	$ 12,862,407	$ 13,276,667

CITY OF PALACIOS, TEXAS

MAJOR ENTERPRISE FUND - AIRPORT FUND
STATEMENT OF NET ASSETS
September 30, 2011
With comparative totals for September 30, 2010

	2011	2010
ASSETS		
Current assets		
Cash and cash equivalents	$ 103,776	$ 116,126
Accounts receivable	450	450
Inventory	22,944	24,649
Total current assets	127,170	141,225
Noncurrent assets		
Capital assets		
Machinery and equipment	80,893	80,893
Buildings and fixtures	66,479	66,479
Land structured facilities	524,577	430,223
Total capital assets	671,949	577,595
Accumulated depreciation	(314,620)	(298,914)
Subtotal	357,329	278,681
Construction in progress	-	94,354
Net capital assets	357,329	373,035
Total assets	484,499	514,260
LIABILITIES		
Accounts payable	2,191	12,383
Due to other funds	33,533	-
Total liabilities	35,724	12,383
NET ASSETS		
Invested in capital assets	357,329	373,035
Unrestricted net assets	91,446	128,842
Total net assets	$ 448,775	$ 501,877

CITY OF PALACIOS, TEXAS

MAJOR ENTERPRISE FUND - AIRPORT FUND
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN FUND NET ASSETS
For the year ended September 30, 2011
With comparative totals for the year ended September 30, 2010

	2011	2010
OPERATING REVENUES		
Charges for services	$ 29,969	$ 42,006
Rental income	30,615	32,345
Total operating revenues	60,584	74,351
OPERATING EXPENSES		
Airport expenses		
Supplies	26,260	36,098
Repairs and maintenance	1,151	1,259
Utilities	11,268	12,806
Insurance and bonds	13,981	13,098
Special items	14,396	24,177
Depreciation	15,706	16,001
Total operating expenses	82,762	103,439
Operating income (loss) before nonoperating revenues (expenses) and transfers	(22,178)	(29,088)
NONOPERATING REVENUES (EXPENSES)		
Investment income		
Interest	150	779
Miscellaneous income (expense)	69	11,904
Nonoperating lease income	23,637	22,175
Total nonoperating revenues (expenses)	23,856	34,858
Income (loss) before transfers	1,678	5,770
Transfers		
Transfer out	(54,780)	(52,595)
Total transfers	(54,780)	(52,595)
Change in net assets	(53,102)	(46,825)
Total net assets at beginning of year	501,877	548,702
Total net assets at end of year	$ 448,775	$ 501,877

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OVERALL COMPLIANCE AND INTERNAL CONTROL SECTION

HARRISON, WALDROP & UHEREK, L.L.P.

HWU

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

The Honorable Mayor and Members
of City Council
City of Palacios, Texas

We have audited the financial statements of the governmental activities, the business-type activities, the discretely presented component unit, and the aggregated remaining fund information of the City of Palacios, Texas (the "City"), as of and for the year ended September 30, 2011, which collectively comprise the City's basic financial statements and have issued our report thereon dated February 10, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

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

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 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 City's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

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

The Honorable Mayor and Members
of City Council

This communication is intended solely for the information and use of management, the Mayor and City Council, others within the organization, and other federal and state awarding agencies and pass-through entities, and is not intended to be and should not be used by anyone other than these specified parties.

Harrison, Waldrop & Uhrenk, LLP

February 10, 2012