CITY OF PALACIOS, TEXAS

ANNUAL FINANCIAL REPORT

For the year ended September 30, 2012

CITY OF PALACIOS, TEXAS
ANNUAL FINANCIAL REPORT
For the year ended September 30, 2012

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INTRODUCTORY SECTION

CITY OF PALACIOS, TEXAS
DIRECTORY OF PRINCIPAL OFFICIALS
September 30, 2012

City Officials	Elective Position
John Sardelich	Mayor
Don Bates	Council Member
Judy Chavez	Council Member
Ed Schulze	Council Member
Gary Hafernick	Council Member
Estella Alamia	Council Member
Troy Lewis	Council Member

Key Staff	Appointive Position
David Kocurek	Public Works Director/ Acting City Mgr
Randall B. Strong	City Attorney
Linh Chau	Municipal Court Judge
Keri Berger	City Secretary
David Miles	Chief of Police

FINANCIAL SECTION

Baker, Stogner & Associates
Certified Public Accountants

316 E Jackson
El Campo, TX 77437

(979) 543-3251
(979) 543-6668 FAX

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, 2012, 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, 2012, 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 28, 2013, 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 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.

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.

Baker, Stogner + Associates

February 28, 2013

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, 2012.

FINANCIAL HIGHLIGHTS

- The assets of the City exceeded its liabilities at the close of the most recent fiscal year by $17,145,786 *(net assets)*. Of this amount, $1,279,840 *(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 $718,450, an increase of $70,415 from the prior year. At the end of the current fiscal year, unassigned fund balance for the General Fund was $596,069, or 25% of total General Fund expenditures.
- The City's total debt of business-type activities decreased by $178,504 or 3% during the fiscal year, ending with a balance of $5,108,289 of which $179,609 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 2011-2012 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 $17,145,786 at the close of the fiscal year 2012.

By far, the largest portion of the City's net assets (92%) 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	
	2012	2011	2012	2011	2012	2011
Current and other assets	$ 1,308,602	$ 1,272,995	$ 3,573,228	$ 4,030,108	$ 4,881,830	$ 5,303,103
Capital assets (net)	2,044,699	1,754,452	15,764,496	15,698,431	17,809,195	17,452,883
Other noncurrent assets	5,140	6,855	142,255	158,911	147,395	165,766
Total assets	3,358,441	3,034,302	19,479,979	19,887,450	22,838,420	22,921,752
Current liabilities	187,087	249,283	396,603	616,615	583,690	865,898
Noncurrent liabilities	176,264	123,400	4,932,680	5,065,465	5,108,944	5,188,865
Total liabilities	363,351	372,683	5,329,283	5,682,080	5,692,634	6,054,763
Invested in capital assets, net of related debt	1,803,716	1,593,552	14,062,230	13,633,939	15,865,946	15,227,491
Unrestricted	1,191,374	1,068,067	88,466	571,431	1,279,840	1,639,498
Total net assets	$ 2,995,090	$ 2,661,619	$ 14,150,696	$ 14,205,370	$ 17,145,786	$ 16,866,989

The balance of unrestricted net assets, $1,279,840, 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 $333,471. Business-type activities decreased the City's net assets by $54,674.

City of Palacios, Texas

Changes in Net Assets

	Governmental Activities		Business-type Activities		Total	
	2012	2011	2012	2011	2012	2011
REVENUES						
Program revenues:						
Charges for services	$ 103,189	$ 97,329	$ 2,320,191	$ 2,302,329	$ 2,423,380	$ 2,399,658
Operating grants and contributions	54,890	53,227	-	-	54,890	53,227
Capital grants and contributions	426,450	116,455	555,490	1,009,298	981,940	1,125,753
General revenues:						
Property taxes	1,351,929	1,249,492	-	-	1,351,929	1,249,492
Sales taxes	486,902	452,682	-	-	486,902	452,682
Franchise taxes	135,269	149,710	-	-	135,269	149,710
Other taxes	24,286	23,420	-	-	24,286	23,420
Unrestricted investment earnings	556	955	4,713	3,028	5,269	3,983
Miscellaneous	96,364	180,437	50,483	42,840	146,847	223,277
Total revenues	2,679,835	2,323,707	2,930,877	3,357,495	5,610,712	5,681,202
EXPENSES						
General government	715,520	735,576	-	-	715,520	735,576
Public safety	1,307,589	1,175,658	-	-	1,307,589	1,175,658
Public works	734,517	438,010	-	-	734,517	438,010
Special services	117,785	152,721	-	-	117,785	152,721
Health and welfare	87,198	62,883	-	-	87,198	62,883
Interest on long-term debt	9,064	13,526	-	-	9,064	13,526
Water and sewer	-	-	2,257,815	2,270,627	2,257,815	2,270,627
Airport	-	-	102,427	82,762	102,427	82,762
Total expenses	2,971,673	2,578,374	2,360,242	2,353,389	5,331,915	4,931,763
Change in net assets before transfers	(291,838)	(254,667)	570,635	1,004,106	278,797	749,439
Transfers	625,309	577,280	(625,309)	(577,280)	-	-
Change in net assets	333,471	322,613	(54,674)	426,826	278,797	749,439
Net assets - beginning	2,661,619	2,339,006	14,205,370	13,778,544	16,866,989	16,117,550
Net assets - ending	$ 2,995,090	$ 2,661,619	$ 14,150,696	$ 14,205,370	$ 17,145,786	$ 16,866,989

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 $118,450, an increase of $70,415 from the prior year.

Approximately 82% of this total amount, $596,069 constitutes unassigned fund balance, which is available for spending at the City's discretion. The remainder of fund balance of $122,381 or 18% 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 $596,069. Unreserved fund balance represents 25% of total General Fund expenditures.

The fund balance of the City's General Fund increased by $47,188 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 $63,581. Unrestricted net assets of the Airport Fund amounted to $24,885 at the end of the current fiscal year, which is a decrease of $125,636 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 $17,809,195 (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 increase in the City's investment in capital assets was 8% (a 6% increase for governmental activities and a 2% increase in business-type activities).

City of Palacios, Texas

Capital Assets (Net of Depreciation)

	Governmental Activities		Business-type Activities		Total	
	2012	2011	2012	2011	2012	2011
Land	$ 357,286	$ 357,286	$ 8,129	$ 7,373	$ 365,415	$ 364,659
Construction in progress	256,341	153,170	489,966	168,968	746,307	322,138
Buildings and improvements	598,559	594,908	497,315	575,532	1,095,874	1,170,440
Machinery and equipment	438,238	328,360	10,527	13,350	448,765	341,710
Land structured facilities	394,274	320,728	1,294,255	435,648	1,688,529	756,376
Water and sewer system	-	-	13,464,305	13,603,372	13,464,305	13,603,372
Total	$ 2,044,698	$ 1,754,452	$ 15,764,497	$ 14,804,243	$ 17,809,195	$ 16,558,695

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 $140,000 of the prior outstanding debt issue, the 2004 General Obligation Refunding Bonds. The amount that is outstanding at year-end totals $3,865,000. The City also retired $37,500 of the tax notes issued in 2008 for the purchase of the new City Hall. The amount outstanding on the tax notes total $123,400. 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 $,168,163.

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 2012-2013 fiscal year.

The total sales tax payments received by the City from the State Comptroller in fiscal year 2012 totaled $486,902. This amount is an increase of $34,220 or 7% over the previous year, indicating a fairly stable pattern (growing pattern) in the retail economy.

The certified assessed taxable property valuations for the 2012 tax roll total $161,263,073 with a tax rate of $0.85787 per $100 valuation. The tax rate remained the same as last year. $0.82549 was allocated for maintenance and operations, and $0.03235 was allocated for interest and sinking (debt service). The projected total property tax due is $1,296,916 for the 2012 tax year. The certified assessed taxable property valuations were less than the 2011 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, $2,236,938 had been reimbursed leaving a balance of $1,168,163.

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, 2012

	Primary Government			Component Unit
	Governmental Activities	Business-type Activities	Total	Palacios Economic Development Corporation
ASSETS				
Current assets				
Cash and cash equivalents	$ 138,824	$ 3,367,751	$ 3,506,575	$ 262,465
Receivables (net)	667,066	469,585	1,136,651	5,701
Internal balances	398,402	(398,402)	-	-
Due from other governments	92,214	-	92,214	29,139
Inventory	12,096	134,294	146,390	-
Total current assets	1,308,602	3,573,228	4,881,830	297,305
Noncurrent assets				
Capital assets				
Land and other assets not being depreciated	613,627	498,095	1,111,722	-
Buildings, improvements, and equipment (net)	1,431,072	15,266,401	16,697,473	-
Deferred expenses (net)	5,140	142,255	147,395	-
Total noncurrent assets	2,049,839	15,906,751	17,956,590	-
Total assets	3,358,441	19,479,979	22,838,420	297,305

	Primary Government			Component Unit
	Governmental Activities	Business-type Activities	Total	Palacios Economic Development Corporation
LIABILITIES				
Current liabilities				
Accounts payable	$ 87,076	$ 80,528	$ 167,604	$ 14,384
Accrued expenses	23,229	8,870	32,099	801
Accrued interest payable	-	17,841	17,841	-
Due to other governments	10,120	-	10,120	-
Customer meter deposits	-	113,755	113,755	-
Accrued compensated absences	1,943	609	2,552	24
Payable to developer	-	35,000	35,000	-
Current portion of long-term obligations	64,719	140,000	204,719	-
Total current liabilities	187,087	396,603	583,690	15,209
Noncurrent liabilities				
Noncurrent portion of long-term obligations	176,264	4,932,680	5,108,944	-
Total noncurrent liabilities	176,264	4,932,680	5,108,944	-
Total liabilities	363,351	5,329,283	5,692,634	15,209
NET ASSETS				
Invested in capital assets, net of related debt	1,803,716	14,062,230	15,865,946	-
Unrestricted net assets	1,191,374	88,466	1,279,840	282,096
Total net assets	$ 2,995,090	$ 14,150,696	$ 17,145,786	$ 282,096

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
$ (699,737)	$ -	$ (699,737)	$ -
(1,220,183)	-	(1,220,183)	-
(253,177)	-	(253,177)	-
(117,785)	-	(117,785)	-
(87,198)	-	(87,198)	-
(9,064)	-	(9,064)	-
(2,387,144)	-	(2,387,144)	-
-	569,823	569,823	-
-	(54,384)	(54,384)	-
-	515,439	515,439	-
(2,387,144)	515,439	(1,871,705)	-
-	-	-	(104,417)
1,298,839	-	1,298,839	-
53,090	-	53,090	-
486,902	-	486,902	162,300
135,269	-	135,269	-
24,286	-	24,286	-
556	4,713	5,269	245
96,364	50,483	146,847	11,401
625,309	(625,309)	-	-
2,720,615	(570,113)	2,150,502	173,946
333,471	(54,674)	278,797	69,529
2,661,619	14,205,370	16,866,989	212,567
$ 2,995,090	$ 14,150,696	$ 17,145,786	$ 282,096

The accompanying notes are an integral part of this statement.

CITY OF PALACIOS, TEXAS
BALANCE SHEET
GOVERNMENTAL FUNDS
September 30, 2012

	General	Other Governmental Funds	Total Governmental Funds
ASSETS			
Current assets			
Cash and cash equivalents	$ 88,702	$ 50,122	$ 138,824
Receivables (net)	476,546	190,520	667,066
Due from other governments	92,214	-	92,214
Due from other funds	533,814	44,986	578,800
Inventory	12,096	-	12,096
Total assets	1,203,372	285,628	1,489,000
LIABILITIES AND FUND BALANCES			
Liabilities			
Accounts payable	53,187	31,844	85,031
Accrued expenditures	23,229	-	23,229
Due to other funds	44,987	135,411	180,398
Due to other governments	5,485	4,635	10,120
Deferred revenue	468,319	3,453	471,772
Total liabilities	595,207	175,343	770,550
Fund balances			
Nonspendable	12,096	-	12,096
Restricted	-	110,285	110,285
Unassigned	596,069	-	596,069
Total fund balances	608,165	110,285	718,450
Total liabilities and fund balances	$ 1,203,372	$ 285,628	$ 1,489,000

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, 2012

Total governmental fund balances		$ 718,450
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.		141,958
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.		471,772
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.		1,783,113
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.		5,140
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	$ (123,400)	
Compensated absences	(1,943)	(125,343)
Net assets of governmental activities		$ 2,995,090

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, 2012

	General	Other Governmental Funds	Total Governmental Funds
REVENUES			
Taxes	$ 1,991,622	$ 72,343	$ 2,063,965
Licenses and permits	15,783	-	15,783
Intergovernmental	-	323,857	323,857
Charges for services	-	-	-
Fines and forfeitures	82,651	4,755	87,406
Investment income	456	95	551
Miscellaneous	105,505	109,482	214,987
Total revenues	2,196,017	510,532	2,706,549
EXPENDITURES			
Current			
General government	635,577	13,040	648,617
Public safety	1,167,945	-	1,167,945
Public works	384,679	473,946	858,625
Special services	117,785	-	117,785
Health and welfare	71,734	-	71,734
Debt service			
Principal retirement	-	37,500	37,500
Interest and fiscal charges	-	7,349	7,349
Total expenditures	2,377,720	531,835	2,909,555
Excess (deficiency) of revenues over expenditures	(181,703)	(21,303)	(203,006)
OTHER FINANCING SOURCES (USES)			
Transfers in	422,280	49,530	471,810
Transfers out	(193,389)	(5,000)	(198,389)
Total other financing sources (uses)	228,891	44,530	273,421
Net change in fund balances	47,188	23,227	70,415
Fund balances at beginning of year	560,978	87,057	648,035
Fund balances at end of year	$ 608,166	$ 110,284	$ 718,450

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, 2012

Total net change in fund balances - governmental funds		$ 70,415
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.		96,021
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.		245,529
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.		(106,991)
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		37,500
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.		(26,720)
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	19,432	17,717
Change in net assets of governmental activities		$ 333,471

The accompanying notes are an integral part of this statement.

CITY OF PALACIOS, TEXAS
STATEMENT OF NET ASSETS
PROPRIETARY FUNDS
September 30, 2012

	Business-type Activities			
	Water and Sewer	Airport	Total	Governmental Activities- Internal Service Fund
ASSETS				
Current assets				
Cash and cash equivalents	$ 3,263,951	$ 103,800	$ 3,367,751	$ -
Receivables (net)	469,010	575	469,585	-
Due from other funds	-	-	-	-
Inventory	104,574	29,720	134,294	-
Total current assets	3,837,535	134,095	3,971,630	-
Noncurrent assets				
Land and other assets not being depreciated	498,095	-	498,095	-
Buildings, improvements, and equipment (net)	14,027,631	1,238,770	15,266,401	261,586
Deferred expenses (net)	142,255	-	142,255	-
Total noncurrent assets	14,667,981	1,238,770	15,906,751	261,586
Total assets	18,505,516	1,372,865	19,878,381	261,586
LIABILITIES				
Current liabilities				
Accounts payable	79,719	809	80,528	2,045
Accrued expenses	8,870	-	8,870	-
Due to other funds	290,001	108,401	398,402	-
Accrued interest payable	17,841	-	17,841	-
Customer meter deposits	113,755	-	113,755	-
Accrued compensated absences	609	-	609	-
Current portion of notes	-	-	-	23,576
Current portion of payable to developer	35,000	-	35,000	-
Current portion of general obligation bonds	140,000	-	140,000	-
Total current liabilities	685,795	109,210	795,005	25,621
Noncurrent liabilities				
Notes payable	-	-	-	94,007
General obligation bonds	145,000	-	145,000	-
Certificates of obligation	3,654,517	-	3,654,517	-
Payable to developer	1,133,163	-	1,133,163	-
Total noncurrent liabilities	4,932,680	-	4,932,680	94,007
Total liabilities	5,618,475	109,210	5,727,685	119,628
NET ASSETS				
Invested in capital assets, net of related debt	12,823,460	1,238,770	14,062,230	144,003
Unrestricted net assets	63,581	24,885	88,466	(2,045)
Total net assets	$ 12,887,041	$ 1,263,655	$ 14,150,696	$ 141,958

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, 2012

	Business-type Activities			
	Water and Sewer	Airport	Total	Governmental Activities- Internal Service Fund
OPERATING REVENUES				
Charges for services	$ 2,272,148	$ 18,001	$ 2,290,149	$ -
Rents	-	30,042	30,042	-
Total operating revenues	2,272,148	48,043	2,320,191	-
OPERATING EXPENSES				
Water system	704,389	-	704,389	-
Sanitary sewer system	243,102	-	243,102	-
Solid waste	602,031	-	602,031	-
Airport expenses	-	62,730	62,730	-
Miscellaneous	17,893	-	17,893	-
Equipment expenses	-	-	-	170,779
Depreciation and amortization	570,596	39,697	610,293	85,094
Total operating expenses	2,138,011	102,427	2,240,438	255,873
Operating income (loss) before nonoperating revenues (expenses) and contributions and transfers	134,137	(54,384)	79,753	(255,873)
NONOPERATING REVENUES (EXPENSES)				
Investment income	4,589	124	4,713	5
Connection fees	18,175	-	18,175	-
Miscellaneous income	2,574	6,097	8,671	-
Nonoperating lease income	-	23,637	23,637	-
Interest and fiscal charges	(119,804)	-	(119,804)	-
Total nonoperating revenues (expenses)	(94,466)	29,858	(64,608)	5
Income (loss) before contributions and transfers	39,671	(24,526)	15,145	(255,868)
Contributions and transfers				
Capital contributions	555,490	-	555,490	-
Transfers in	-	-	-	351,889
Transfers out	(570,529)	(54,780)	(625,309)	-
Total contributions and transfers	(15,039)	(54,780)	(69,819)	351,889
Change in net assets	24,632	(79,306)	(54,674)	96,021
Total net assets at beginning of year	12,862,409	1,342,961	14,205,370	45,937
Total net assets at end of year	$ 12,887,041	$ 1,263,655	$ 14,150,696	$ 141,958

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, 2012

	Business-type Activities			Governmental Activities- Internal Service Fund
	Water and Sewer	Airport	Total	
CASH FLOWS FROM OPERATING ACTIVITIES				
Cash received from customers	$ 2,119,798	$ 47,918	$ 2,167,716	$ -
Cash paid to suppliers for goods and services	(1,303,356)	(70,888)	(1,374,244)	(212,000)
Cash paid to employees for services	(403,531)	-	(403,531)	-
Net cash provided (used) by operating activities	412,911	(22,970)	389,941	(212,000)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES				
Transfers (to) from other funds	(570,529)	(54,780)	(625,309)	230,000
Borrowings (repayments) to other funds	18,383	74,868	93,251	(559)
Connection fees	18,175	-	18,175	-
Miscellaneous income (expense)	2,574	29,734	32,308	-
Increase (decrease) in customer meter deposits	2,810	-	2,810	-
Net cash provided (used) by noncapital financing activities	(528,587)	49,822	(478,765)	229,441
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES				
Acquisition and construction of capital assets	(89,404)	(26,952)	(116,356)	-
Increase in bond issue costs	12,144	-	12,144	-
Proceeds from issuance of debt	-	-	-	-
Principal paid on long-term debt	(172,785)	-	(172,785)	-
Interest paid	(212,283)	-	(212,283)	-
Net cash provided (used) by capital and related financing activities	(462,328)	(26,952)	(489,280)	-
CASH FLOWS FROM INVESTING ACTIVITIES				
Investment income	4,589	124	4,713	19
Net cash provided (used) by investing activities	4,589	124	4,713	19
Net increase (decrease) in cash and cash equivalents	(573,415)	24	(573,391)	17,460
Cash and cash equivalents at beginning of year	3,837,366	103,776	3,941,142	-
Cash and cash equivalents at end of year	$ 3,263,951	$ 103,800	$ 3,367,751	$ 17,460

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
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES				
Operating income (loss)	$ 134,137	$ (22,178)	$ 111,959	$ (263,230)
Adjustments to reconcile operating income to net cash provided by operating activities				
Depreciation and amortization	570,596	15,706	586,302	52,181
Changes in assets and liabilities				
(Increase) decrease in accounts receivable	(152,350)	-	(152,350)	-
(Increase) decrease in inventory	(50,511)	1,705	(48,806)	-
Increase (decrease) in accounts payable	(86,458)	(10,192)	(96,650)	(951)
Increase (decrease) in accrued expenses	3,216	-	3,216	-
Increase (decrease) in compensated absences	(5,719)	-	(5,719)	-
Total adjustments	278,774	7,219	285,993	51,230
Net cash provided (used) by operating activities	$ 412,911	$ (14,959)	$ 397,952	$ (212,000)
Noncash capital and related financing activities				
Infrastructure improvements contributed by other funds	$ 512,963			

The accompanying notes are an integral part of this statement.

CITY OF PALACIOS, TEXAS
STATEMENT OF FIDUCIARY NET ASSETS
FIDUCIARY FUNDS
September 30, 2012

	Agency Fund
ASSETS	
Cash and cash equivalents	$ 210,821
Total assets	$ 210,821
LIABILITIES	
Liabilities	
Due to others	$ 210,821
Total liabilities	$ 210,821

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, 2012.

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

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.

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.

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

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

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.

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, 2012, 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.

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

I. Capital Assets - (Continued)

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.

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 five departments that expenditures exceeded the amount appropriated during the fiscal year 2011-2012.

General Fund - Department	Final Budget	Actual	Negative Variance
Mayor and Council	$ 19,750	$ 20,428	$ (678)
Police	993,820	1,150,816	(156,996)
Park maintenance	137,300	141,550	(4,250)
Recycling center	42,140	52,667	(10,527)
Animal Control	6,940	19,067	(12,127)

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, 2012, the City had the following investments:

Investment Type	Amortized Cost	Weighted Average Maturity (Days)
Public Funds Investment Pool		
TexPool	$ 3,423,066	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

NOTE 3: DEPOSITS AND INVESTMENTS – (Continued)

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, 2012, consist of the following:

	General	Water and Sewer	Airport Fund	Nonmajor Funds	Total
Gross receivables:					
Accounts	$ 43,500	$ 487,341	$ 575	$ -	$ 531,416
Ad valorem taxes	647,061	-	-	9,720	656,781
Franchise taxes	15,509	-	-	-	15,509
Fines	68,956	-	-	-	68,956
Other	-	158,134	-	181,184	339,318
Total gross receivables	775,026	645,475	575	190,904	1,611,980
Less: allowances	298,480	176,465	-	384	475,329
Total net receivables	$ 476,546	$ 469,010	$ 575	$ 190,520	$1,136,651

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	$ 383,235	$ -	$ 383,235
Fines	73,394	-	73,394
Weedy lot mowing	11,690	-	11,690
Debt Service Fund			
Ad valorem taxes	3,453	-	3,453
	$ 471,772	$ -	$ 471,772

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 $0.85787 per $100 of assessed valuation. $0.82549 was allocated for maintenance and operations, and $0.03238 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 $161,263,073 for the 2011 tax roll.

NOTE 5: CAPITAL ASSETS

The City's capital assets activity for the year ended September 30, 2012, 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	103,171	-	256,341
Total capital assets not being depreciated	510,456	103,171	-	613,627
Capital assets, being depreciated				
Machinery and equipment	1,861,909	236,802	25,877	2,072,834
Land structured facilities	4,222,464	121,354	-	4,343,818
Buildings	863,826	21,003	-	884,829
Total capital assets being depreciated	6,948,199	379,159	25,877	7,301,481
Less accumulated depreciation for				
Machinery and equipment	1,533,549	126,924	25,877	1,634,596
Land structured facilities	3,901,736	47,808	-	3,949,544
Buildings	268,918	17,352	-	286,270
Total accumulated depreciation	5,704,203	192,084	25,877	5,870,410
Total capital assets being depreciated, net	1,243,996	187,075	-	1,431,071
Governmental activities capital assets, net	$ 1,754,452	$ 290,246	$ -	$ 2,044,698
Business-type activities				
Capital assets, not being depreciated				
Land	$ 7,373	$ 756	$ -	$ 8,129
Construction in progress	168,968	320,998	-	489,966
Total capital assets not being depreciated	176,341	321,754	-	498,095
Capital assets, being depreciated				
Machinery and equipment	624,638	-	52,959	571,679
Buildings and improvements	3,471,118	-	-	3,471,118
Water and sewer system	16,961,369	323,141	-	17,284,510
Land structured facilities	2,178,947	26,952	-	2,205,899
Total capital assets being depreciated	23,236,072	350,093	52,959	23,533,206
Less accumulated depreciation for				
Machinery and equipment	611,289	2,822	52,959	561,152
Buildings and improvements	2,884,638	89,165	-	2,973,803
Water works system	3,357,997	462,208	-	3,820,205
Land structured facilities	860,060	51,584	-	911,644
Total accumulated depreciation	7,713,984	605,779	52,959	8,266,804
Total capital assets being depreciated, net	15,522,088	(255,686)	-	15,266,402
Business-type activities capital assets, net	$15,698,429	$ 66,068	$ -	$15,764,497

NOTE 5: CAPITAL ASSETS – (Continued)

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

Governmental activities	
General government	$ 63,352
Public safety	60,685
Public works	58,224
Public health	9,823
Total depreciation expense - governmental activities	$ 192,084
Business-type activities	
Utilities	$ 566,083
Airport	39,696
Total depreciation expense - business-type activities	$ 605,779

The Palacios Economic Development Corporation has $12,799 of capital assets at September 30, 2012, consisting of various equipment and leasehold improvements. These assets were fully depreciated at September 30, 2012.

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 from 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 2011	Plan Year 2012
Employee deposit rate	5.0%	7.0%
Matching ratio (city to employee)	2 to 1	2 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
2012	$ 114,492	100%	$ -
2011	105,366	100%	-
2010	90,083	100%	-
2009	80,812	100%	-

The required contribution rates for fiscal year 2012 were determined as part of the December 31, 2009 and 2010 actuarial valuations. Additional information as of the latest actuarial valuation, December 31, 2011, also follows:

Actuarial Valuation Information

	12/31/11 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

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

Schedule of Funding Status

Actuarial Valuation Date	Actuarial Value of Assets	Actuarial Accrued Liability (AAL)	Unfunded AAL (UAAL)	Funded Ratio	Annual Covered Payroll	UAAL as a Percentage of Covered Payroll
	(a)	(b)	(b-a)	(a/b)	(c)	((b-a)/c)
12/31/2011	$ 2,498,805	$ 3,815,360	$ 1,316,555	65.5%	$1,347,581	97.7%

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.

Required Supplementary Information

Texas Municipal System

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)
12/31/2009	$ 1,330,616	$ 2,005,641	$ 675,025	66.3%	$ 1,236,169	54.6%
12/31/2010	2,263,123	3,465,504	1,202,381	65.3%	1,278,418	94.1%
12/31/2011	2,498,805	3,815,360	1,316,555	65.5%	1,347,581	97.7%

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, 2012, there were 214 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.

At August 31, 2012, TESRS membership consisted of:

Retirees & Beneficiaries Currently Receiving Benefits	2,758
Terminated Members Entitled to Benefits, but not yet receiving them	2,260
Active Participants (Vested and Nonvested)	4,230

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.

TLFFRA

When a department with Texas Local Fire Fighters Retirement Act (TLFFRA) pension plan elects to participate in the TESRS, the TLFFRA pension plan is dissolved and merged into the TESRS pension system. TLFFRA is an agent multi-employer plan. On the date of the merger, all assets and liabilities of the TLFFRA pension plan are merged with TESRS on an actuarially sound basis and become an allocated part of the system Those members receiving retirement benefits under the former TLFFRA pension are converted into the TESRS pension system as if they had been TESRS members as of entry date. This conversion is determined actuarially through cost studies.

At August 31, 2012, the pension system membership consisted of:

Retirees and Beneficiaries Currently Receiving Benefits	411

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

Membership of this plan as of August 31, 2012 was merged in its entirety into TESRS.

Funding Policy

TESRS

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 ($36) 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.

Approximately 85% of the costs of administering the plan for fiscal year 2012 was financed through general revenue appropriations, the other 15% being funded through TESRS.

TLFFRA

The costs of the TLFFRA pension plan merger are determined on an actuarially sound basis. The costs must be certified by a qualified actuary as of the effective date of the merger or within two years following the date of merger. If the governing body has insufficient funds to pre-fund for liabilities, the TESRS State Board by rule may allow for a payment plan. The liabilities of the merged TSFFRA pension plan are then administered by FFPC invoicing the local governing bodies for payment. These payments are always equal to the merged TLFFRA pension benefits and therefore, there is no fund balance. As of August 31, 2012, there was 1 plan merged into the TESRS pension system.

Contributions Required and Contributions Made

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, and there is no maximum contribution rate. For the fiscal year ending August 31, 2012, total contributions (dues and prior services) of $3,517,455 were paid into TESRS by the political subdivisions served by the member volunteer emergency services personnel. The State did not appropriate any state contribution for the fiscal years ending August 31, 2011 and 2012.

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. Actuarial assumptions made include level dollar, open amortization method, and a 30 year amortization period. Relating to the Actuarial Value of Assets – all assets are valued at market value as determined by the System Board of Trustees, with an adjustment made to uniformly spread the recognition of actuarial gains or losses (as measured by actual market value investment return vs assumed market value investment return) over a five-year period. The total adjustment amount shall be limited as necessary such that the actuarial value of assets shall not be less than 80% of market value nor greater than 120% of market value.

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 and with the assumed continuation of legislative appropriations of (1) the maximum state contribution rate in future years for up to 30 years as is necessary for the System to have a 30-year amortization period, and (2) approximately $500,000 each year to help pay for the system's administrative expenses. The last actuarial valuation was conducted as of August 31, 2010, and revised in April of 2011, thus the numbers in this Annual Financial Report are different from those presented in 2010. On August 31, 2010 the actuarial liabilities exceeded the actuarial assets by $17,150,427. The actuarial valuation for fiscal year ending

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

August 31, 2012 is currently being conducted, however, the results are not available at the time of issuance of this financial report.

TLFFRA

Currently, contributions are not actuarially determined. Contributions are made by local governing bodies of the former TLFFRA plans on a pay as you go basis. Those members receiving retirement benefits under the merged TLFFRA pension plan are converted into the TESRS pension system. For the fiscal year ended August 31, 2012, total contributions from local bodies for merged TLFFRA pension benefits were $373,189.

Six-Year Historical Trend Information

TESRS

The information presented in the required supplementary schedules was determined as part of the actuarial valuation at the date indicated. Actuarial assumptions and methods of the latest valuation follows.

Valuation date	August 31, 2010
Actuarial cost method	Entry Age
Amortization method	Level dollar, open
Amortization period	30 years
Asset valuation method	Market value smoothed by a 5 year deferred recognition method with a 80%/120% corridor on market value
Actuarial assumptions:	
Investment rate of return	7.75% per year, net of investment expenses
Projected salary increases	N/A
Includes inflation at	3.50%
Cost of living adjustments	None

The schedule of funding progress as of the latest actuarial valuation completed is shown in the table below:

Actuarial Valuation Date	Actuarial Value of Assets a	Actuarial Accrued Liability (AAL) - Entry Age b	Unfunded AAL (UAAL) b - a	Funded Ratio a/b	Total Members Covered c	UAAL Per Member Covered (b-a)/c
8/31/2010	$ 64,113,803	$ 81,264,230	$ 17,150,427	78.9%	$ 8,644	$ 1,984

The required Schedule of Funding Progress immediately following the notes to the financial statements presents multiyear trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liability for benefits.

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

The projection of benefits for financial reporting purposes does not explicitly incorporate the potential effect of legal or contractual funding limitations, if applicable.

TLFFRA
No RSI is presented for TLFFRA. It is not cost beneficial to obtain actuarial valuations for the TLFFRA plans, which are pay as your go. Local municipal governments are liable for the payments.
Required Supplementary Information

Schedule of Funding Progress

Actuarial Valuation Date	Actuarial Value of Assets a	Liability (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	60,987,157	64,227,341	3,240,184	95.0%	8,254	393
8/31/2010	64,113,803	81,264,230	17,150,427	78.9%	8,644	1,984

Schedule of Contributions From the Employers and Other Contributing Entities

Fiscal Year Ending August 31,	Annural Required Contributions	Actual Contributions	Percentage Contributed
2005	$ 3,206,300	$ 1,606,759	50%
2006	2,753,035	2,753,035	100%
2007	3,162,742	3,162,742	100%
2008	3,160,764	11,239,339	356%
2009	2,698,271	2,698,271	100%
2010	2,875,103	2,875,103	100%

State contributions to the City's plan for the fiscal year 2012 have 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
2012	20,646	100%	
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, 2012, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Due Within One Year
Governmental activities					
Tax notes	$ 160,900	$ -	$ 37,500	$ 123,400	$ 39,200
Compensated absences	21,375	-	19,432	1,943	1,943
Equipment notes	-	129,604	12,021	117,583	23,576
Total governmental activity long-term liabilities	$ 182,275	$ 129,604	$ 68,953	$ 242,926	$ 64,719
Business-type activities					
General obligation bonds	$ 425,000	$ -	$ 140,000	$ 285,000	$ 140,000
Certificates of obligation	3,580,000	-	-	3,580,000	-
Issuance premium	74,517	-	-	74,517	-
Compensated absences	6,328	-	5,719	609	609
Payable to developer	1,200,948	-	32,785	1,168,163	35,000
Total business-type activity long-term liabilities	$ 5,286,793	$ -	$ 178,504	$ 5,108,289	$ 175,609

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 $285,000 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
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
	$ 3,865,000	$ 1,544,650	$ 5,409,650

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
2013	39,200	5,105	44,305
2014	41,100	3,537	44,637
2015	43,100	1,832	44,932
	$ 123,400	$ 10,474	$ 133,874

D. Equipment Notes

The City financed equipment with capital leases. The annual debt service requirement and maturity are as follows:

Year	Principal	Interest	Total
2013	23,576	4,217	27,794
2014	25,117	4,062	29,180
2015	26,358	2,822	29,180
2016	27,663	1,516	29,180
2017	14,867	451	15,319
Totals	117,583	13,070	130,653

E. 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, and $32,785 for the 2009, 2010, 2011, and 2012 fiscal years, respectively. The City has recorded the net liability of $1,168,163 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 $35,000.

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

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

A. Interfund Receivables and Payables – (Continued)

fund that belongs to or is designated for another fund. Interfund receivable and payable balances as of September 30, 2012, were as follows:

Receivable Fund	Payable Fund	Amount
General	Airport	$ 108,401
	Nonmajor Governmental	135,411
	Water and Sewer	290,001
Nonmajor Governmental	General	44,987
		$ 578,800

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	Nonmajor Governmental	Total
General	$ -	$ 191,889	$ 1,500	$ 193,389
Nonmajor Governmental	5,000	-	-	5,000
Water and Sewer	382,500	140,000	48,029	570,529
Airport	34,780	20,000	-	54,780
	$ 422,280	$ 351,889	$ 49,529	$ 823,698

NOTE 12: COMMITMENTS AND CONTINGENCIES

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, 2012, 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, 2012:

	Governmental Fund Balances			
	Nonspendable	Restricted	Unassigned	Total
General				
Inventory	$ 12,096	$ -	$ -	$ 12,096
Unassigned	-	-	596,069	596,069
Nonmajor Governmental				
Retirement of long-term debt	-	52,842	-	52,842
Municipal court	-	27,055	-	27,055
State and federal grant programs	-	19,836	-	19,836
Public safety	-	6,077	-	6,077
Tourism	-	4,475	-	4,475
	$ 12,096	$ 110,285	$ 596,069	$ 718,450

NOTE 14: RESTATEMENT OF NET ASSETS

The beginning net assets of the Airport Fund was restated to reflect renovations via a TXDOT grant that were not recorded in the prior year. The result of this restatement was an increase of $894,186 to capital assets and invested in capital assets. The 2011 amounts were changed for comparative purposes.

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, 2012

	Original Budget	Final Budget	Actual	Variance Positive (Negative)
REVENUES				
Taxes				
Ad valorem taxes	$ 1,287,900	$ 1,287,900	$ 1,364,418	$ 76,518
Other taxes	606,600	606,600	627,204	20,604
Licenses and permits	16,800	16,800	15,783	(1,017)
Intergovernmental	1,300	1,300	-	(1,300)
Charges for services	-	-	-	-
Fines and forfeitures	45,000	45,000	82,651	37,651
Investment income	900	900	456	(444)
Miscellaneous	106,570	106,570	105,505	(1,065)
Total revenues	2,065,070	2,065,070	2,196,017	130,947
EXPENDITURES				
Current				
General government	677,170	677,170	635,577	41,593
Public safety	1,031,740	1,031,740	1,167,945	(136,205)
Public works	435,480	435,480	384,679	50,801
Special services	165,900	165,900	117,785	48,115
Health and welfare	49,080	49,080	71,734	(22,654)
Debt service	-	-	-	-
Total expenditures	2,359,370	2,359,370	2,377,720	(18,350)
Excess (deficiency) of revenues over expenditures	(294,300)	(294,300)	(181,703)	112,597
OTHER FINANCING SOURCES (USES)				
Transfers in	424,560	424,560	422,280	(2,280)
Transfers out	(70,000)	(70,000)	(193,389)	(123,389)
Total other financing sources (uses)	354,560	354,560	228,891	(125,669)
Net change in fund balance	60,260	60,260	47,188	(13,072)
Fund balance at beginning of year	560,978	560,978	560,978	-
Fund balance at end of year	$ 621,238	$ 621,238	$ 608,166	$ (13,072)

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)
12/31/2009	$ 1,330,616	$ 2,005,641	$ 675,025	66.3%	$ 1,236,169	54.6%
12/31/2010	2,263,123	3,465,504	1,202,381	65.3%	1,278,418	94.1%
12/31/2011	2,498,805	3,815,360	1,316,555	65.5%	1,347,581	97.7%

TEXAS EMERGENCY SERVICES RETIREMENT SYSTEM

Valuation date	August 31, 2010
Actuarial cost method	Entry Age
Amortization method	Level dollar, open
Amortization period	30 years
Asset valuation method	Market value smoothed by a 5 year deferred recognition method with a 80%/120% corridor on market value
Actuarial assumptions:	
Investment rate of return	7.75% per year, net of investment expenses
Projected salary increases	N/A
Includes inflation at	3.50%
Cost of living adjustments	None

TEXAS EMERGENCY SERVICES RETIREMENT SYSTEM - (Continued)

Schedule of Funding Progress

Actuarial Valuation Date	Actuarial Value of Assets a	Actuarial Accrued Liability (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	60,987,157	64,227,341	3,240,184	95.0%	8,254	393
8/31/2010	64,113,803	81,264,230	17,150,427	78.9%	8,644	1,984

Schedule of Contributions From the Employers and Other Contributing Entities

Fiscal Year Ending August 31,	Annural Required Contributions	Actual Contributions	Percentage Contributed
2005	$ 3,206,300	$ 1,606,759	50%
2006	2,753,035	2,753,035	100%
2007	3,162,742	3,162,742	100%
2008	3,160,764	11,239,339	356%
2009	2,698,271	2,698,271	100%
2010	2,875,103	2,875,103	100%

State contributions to the City's plan for the fiscal year 2012 has been deemed insignificant to the financial statements. Therefore, no amounts have been recognized as revenues and expenditures during the period.

Trend Information - City of Palacios, Texas

Year Ended August 31,	Annual Required Contributions	Percentage of ARC Contributed	Net Obligation
2012	$ 20,646	100%	$ -
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, 2012 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
Mayor and City Council	$ 19,750	$ 20,428	$ (678)
Police	993,820	1,150,816	(156,996)
Park maintenance	137,300	141,550	(4,250)
Recycling center	42,140	52,667	(10,527)
Animal control	6,940	19,067	(12,127)

Combining and Individual Fund Statements and Schedules

CITY OF PALACIOS, TEXAS
NONMAJOR GOVERNMENTAL FUNDS
COMBINING BALANCE SHEET
September 30, 2012

	Special Revenue Funds			
	Police Seized Drug	Hotel Motel Tax	TCDP Sewer Project	Pavilion Restoration Fund
ASSETS				
Cash and cash equivalents	$ 4,635	$ -	$ -	$ 3,186
Receivables (net)				
Taxes	-	5,883	-	-
Other	-	-	31,844	-
Due from other funds	-	-	-	-
Total assets	$ 4,635	$ 5,883	$ 31,844	$ 3,186
LIABILITIES AND FUND BALANCES				
Liabilities				
Accounts payable	$ -	$ -	$ 31,844	$ -
Due to other funds	-	1,408	-	-
Deferred revenue	-	-	-	-
Due to other governments	4,635	-	-	-
Total liabilities	4,635	1,408	31,844	-
Fund balances				
Restricted				
Public safety	-	-	-	-
Tourism	-	4,475	-	-
State and federal grant programs	-	-	-	3,186
Municipal court	-	-	-	-
Debt service	-	-	-	-
Total fund balances	-	4,475	-	3,186
Total liabilities and fund balances	$ 4,635	$ 5,883	$ 31,844	$ 3,186

Special Revenue Funds						
TDHCA Home Program	Safe School Sidewalk	Court Technology	Court Security	Forfeiture Funds	Judicial Efficiency	Safe School Bridge
$ -	$ -	$ 15,696	$ 11,359	$ 4,886	$ 1,191	$ -
-	-	-	-	-	-	-
4,890	74,682	-	-	-	-	69,581
-	-	-	-	-	-	-
$ 4,890	$ 74,682	$ 15,696	$ 11,359	$ 4,886	$ 1,191	$ 69,581
$ -	$ -	$ -	$ -	$ -	$ -	$ -
4,890	74,682	-	-	-	-	54,431
-	-	-	-	-	-	-
-	-	-	-	-	-	-
4,890	74,682	-	-	-	-	54,431
-	-	-	-	4,886	1,191	-
-	-	-	-	-	-	-
-	-	-	-	-	-	15,150
-	-	15,696	11,359	-	-	-
-	-	-	-	-	-	-
-	-	15,696	11,359	4,886	1,191	15,150
$ 4,890	$ 74,682	$ 15,696	$ 11,359	$ 4,886	$ 1,191	$ 69,581

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CITY OF PALACIOS, TEXAS
NONMAJOR GOVERNMENTAL FUNDS
COMBINING BALANCE SHEET
September 30, 2012

	Disaster Recovery Fund	Debt Service Fund	Total
ASSETS			
Cash and cash equivalents	$ 1,500	$ 7,669	$ 50,122
Receivables (net)			
Taxes	-	3,453	9,336
Other	-	187	181,184
Due from other funds	-	44,986	44,986
Total assets	$ 1,500	$ 56,295	$ 285,628
LIABILITIES AND FUND BALANCES			
Liabilities			
Accounts payable	$ -	$ -	$ 31,844
Due to other funds	-	-	135,411
Deferred revenue	-	3,453	3,453
Due to other governments	-	-	4,635
Total liabilities	-	3,453	175,343
Fund balances			
Restricted			
Public safety	-	-	6,077
Tourism	-	-	4,475
State and federal grant programs	1,500	-	19,836
Municipal court	-	-	27,055
Debt service	-	52,842	52,842
Total fund balances	1,500	52,842	110,285
Total liabilities and fund balances	$ 1,500	$ 56,295	$ 285,628

(concluded)

CITY OF PALACIOS, TEXAS
NONMAJOR GOVERNMENTAL FUNDS
COMBINING STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES
For the year ended September 30, 2012

	Special Revenue Funds			
	Police Seized Drug	Hotel Motel Tax	TCDP Sewer Project	Pavilion Restoration Fund
REVENUES				
Taxes				
Hotel - motel tax	$ -	$ 19,253	$ -	$ -
Ad valorem taxes	-	-	-	-
Court fees	-	-	-	-
Intergovernmental	-	-	317,455	-
Investment income				
Interest	-	-	-	-
Miscellaneous	-	2,000	-	-
Total revenues	-	21,253	317,455	-
EXPENDITURES				
Current				
General government				
Promotional expense	-	13,040	-	-
Public works	-	-	365,485	-
Principal				
Interest	-	-	-	-
Total expenditures	-	13,040	365,485	-
Excess (deficiency) of revenues over expenditures	-	8,213	(48,030)	-
OTHER FINANCING SOURCES (USES)				
Transfers in (out)	-	(5,000)	48,030	-
Total other financing sources (uses)	-	(5,000)	48,030	-
Net change in fund balances	-	3,213	-	-
Fund balances at beginning of year	-	1,262	-	3,185
Fund balances at end of year	$ -	$ 4,475	$ -	$ 3,185

Special Revenue Funds						
TDHCA Home Program	Safe School Sidewalk	Court Technology	Court Security	Forfeiture Funds	Judicial Efficiency	Safe School Bridge
$ -	$ -	$ -	$ -	$ -	$ -	$ -
-	-	-	-	-	-	-
-	-	2,595	1,967	-	193	-
4,890	1,512	-	-	-	-	-
-	-	-	11	1	-	83
-	-	-	-	-	-	107,482
4,890	1,512	2,595	1,978	1	193	107,565
-	-	-	-	-	-	-
4,890	1,512	-	-	400	-	101,659
-	-	-	-	-	-	-
4,890	1,512	-	-	400	-	101,659
-	-	2,595	1,978	(399)	193	5,906
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	2,595	1,978	(399)	193	5,906
-	-	13,101	9,381	5,285	998	9,244
$ -	$ -	$ 15,696	$ 11,359	$ 4,886	$ 1,191	$ 15,150

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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, 2012

	Disaster Recovery Fund	Debt Service Fund	Total
REVENUES			
Taxes			
Hotel - motel tax	$ -	$ -	$ 19,253
Ad valorem taxes	-	53,090	53,090
Court fees	-	-	4,755
Intergovernmental	-	-	323,857
Investment income			
Interest	-	-	95
Miscellaneous	-	-	109,482
Total revenues	-	53,090	510,532
EXPENDITURES			
Current			
General government			
Promotional expense	-	-	13,040
Public works	-	-	473,946
Principal	-	37,500	37,500
Interest	-	7,349	7,349
Total expenditures	-	44,849	531,835
Excess (deficiency) of revenues over expenditures	-	8,241	(21,303)
OTHER FINANCING SOURCES (USES)			
Transfers in (out)	1,500	-	44,530
Total other financing sources (uses)	1,500	-	44,530
Net change in fund balances	1,500	8,241	23,227
Fund balances at beginning of year	-	44,601	87,057
Fund balances at end of year	$ 1,500	$ 52,842	$ 110,284

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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, 2012
With comparative totals for September 30, 2011

	2012	2011
ASSETS		
Cash and cash equivalents	$ 88,702	$ 97,484
Receivables (net)		
Accounts	16,059	26,820
Taxes	391,532	414,651
Fines	68,956	70,908
Due from other governments	92,214	132,083
Due from other funds	533,813	380,278
Inventory	12,096	6,360
Total assets	$ 1,203,372	$ 1,128,584
LIABILITIES AND FUND BALANCES		
Liabilities		
Accounts payable	$ 53,187	$ 41,823
Accrued expenses	23,229	16,890
Due to other funds	44,987	4,210
Due to other governments	5,485	9,864
Deferred revenue	468,319	494,819
Total liabilities	595,207	567,606
Fund balances		
Nonspendable	12,096	6,360
Unassigned	596,069	554,618
Total fund balances	608,165	560,978
Total liabilities and fund balances	$ 1,203,372	$ 1,128,584

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, 2012
With comparative totals for the year ended September 30, 2011

	2012			2011
	Final Budget	Actual	Variance Positive (Negative)	Actual
REVENUES				
Ad valorem taxes				
Current and delinquent taxes	$ 1,243,400	$ 1,298,838	$ 55,438	$ 1,204,891
Penalty and interest	43,500	60,500	17,000	41,463
Tax certificates, other fees	1,000	5,080	4,080	661
Total ad valorem taxes	1,287,900	1,364,418	76,518	1,247,015
Other taxes				
Sales tax	302,000	324,613	22,613	301,788
Property tax reduction sales tax	151,000	162,289	11,289	150,894
Franchise tax	145,000	135,269	(9,731)	149,710
Bingo tax	2,600	819	(1,781)	1,507
Mixed beverage tax	6,000	4,214	(1,786)	4,424
Total other taxes	606,600	627,204	20,604	608,323
Licenses and permits				
Building and moving permits	14,600	11,491	(3,109)	13,495
Dog licenses	2,200	4,292	2,092	1,815
Total licenses and permits	16,800	15,783	(1,017)	15,310
Intergovernmental				
Grant proceeds	1,300	-	(1,300)	1,307
Charges for services				
Weedy lot mowing	-	-	-	571
Economic development	-	-	-	18,180
Total charges for services	-	-	-	18,751
Fines and forfeitures				
Fines and court costs	45,000	82,651	37,651	58,357
Investment income				
Interest	900	456	(444)	797
Miscellaneous				
Insurance reimbursement	16,700	19,778	3,078	20,955
Maintenance contract	50,000	50,000	-	50,000
Other	39,870	35,727	(4,143)	68,566
Total miscellaneous	106,570	105,505	(1,065)	139,521
Total revenues	2,065,070	2,196,017	130,947	2,089,381

(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, 2012
With comparative totals for the year ended September 30, 2011

	2012			2011
	Final Budget	Actual	Variance Positive (Negative)	Actual
EXPENDITURES				
General government				
Mayor and city council				
Salaries and wages	$ 10,200	$ 13,600	$ (3,400)	$ 9,400
Office supplies	1,400	1,318	82	1,596
Special services	3,620	1,042	2,578	3,400
Travel, training, and dues	3,700	3,303	397	3,987
Social security tax	790	1,132	(342)	876
Employee benefits	40	33	7	35
Capital outlay	-	-	-	7,759
Total mayor and city council	19,750	20,428	(678)	27,053
Elections				
Office supplies	1,150	93	1,057	99
Special services	780	-	780	-
Total elections	1,930	93	1,837	99
Administrative				
Salaries and wages	305,660	278,135	27,525	280,135
Office supplies	9,000	10,508	(1,508)	10,201
Maintenance - office equipment	16,980	16,539	441	12,530
Maintenance - buildings	1,140	681	459	865
Telephone	7,400	5,901	1,499	7,102
Electricity	6,500	3,992	2,508	5,689
Gas	300	265	35	273
Professional fees	11,980	10,954	1,026	10,537
Special services	38,660	49,587	(10,927)	44,116
Travel, training, and dues	7,600	7,381	219	6,944
Social security tax	23,390	21,501	1,889	22,220
Employee benefits	92,530	82,215	10,315	75,804
Capital outlay	5,090	6,029	(939)	4,250
Total administrative	526,230	493,688	32,542	480,666
Legal				
Special services	11,000	7,959	3,041	12,873

(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, 2012
With comparative totals for the year ended September 30, 2011

	2012			2011
	Final Budget	Actual	Variance Positive (Negative)	Actual
EXPENDITURES - (CONTINUED)				
General government - (continued)				
Corporation court				
Salaries and wages	$ 62,470	$ 60,599	$ 1,871	$ 57,282
Office supplies	300	1,563	(1,263)	226
Maintenance - office equipment	4,030	4,100	(70)	3,600
Telephone	600	558	42	559
Special services	950	853	97	778
Travel, training, and dues	1,500	887	613	1,075
Social security tax	4,780	4,618	162	4,549
Employee benefits	11,350	11,231	119	9,482
Capital outlay	2,280	-	2,280	1,647
Total corporation court	88,260	84,409	3,851	79,198
Library				
Special services	30,000	29,000	1,000	36,250
Total general government	677,170	635,577	41,593	636,139
Public safety				
Police department				
Salaries and wages	647,320	763,884	(116,564)	693,263
Minor tools	3,600	6,440	(2,840)	3,217
Office supplies	5,500	7,216	(1,716)	4,850
Clothing	4,000	1,645	2,355	3,472
Maintenance - buildings	890	858	32	1,020
Maintenance - radios/radar	500	-	500	-
Maintenance - office equipment	15,980	19,937	(3,957)	16,099
Telephone, electricity, and gas	17,480	20,760	(3,280)	16,724
Special services	11,820	38,550	(26,730)	18,418
Travel, training, and dues	8,000	7,330	670	6,115
Support of prisoners	700	607	93	508
Social security tax	49,520	58,446	(8,926)	55,301
Employee benefits	218,210	210,080	8,130	158,384
Capital outlay	10,300	15,063	(4,763)	12,413
Total police department	993,820	1,150,816	(156,996)	989,784

(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, 2012
With comparative totals for the year ended September 30, 2011

	2012			2011
	Final Budget	Actual	Variance Positive (Negative)	Actual
EXPENDITURES - (CONTINUED)				
Public safety - (continued)				
Fire department				
Supplies	$ 500	$ -	$ 500	$ 245
Chemicals	500	-	500	-
Maintenance - equipment	200	-	200	-
Maintenance - buildings	2,000	3,480	(1,480)	-
Maintenance - radios	-	-	-	-
Telephone	1,100	994	106	1,152
Electricity	1,200	1,060	140	1,254
Gas	200	284	(84)	211
Travel, training, and dues	1,500	-	1,500	-
Special services	9,220	10,854	(1,634)	13,186
Employee benefits	500	457	43	492
Capital outlay	21,000	-	21,000	9,347
Total fire department	37,920	17,129	20,791	25,887
Total public safety	1,031,740	1,167,945	(136,205)	1,015,671
Public works				
Park maintenance				
Salaries	-	2,758	(2,758)	-
Tools and supplies	6,800	5,985	815	12,160
Chemicals	1,200	12	1,188	-
Reconstruction materials	1,000	-	1,000	-
Electricity	28,000	19,869	8,131	21,644
Special services	100,300	112,481	(12,181)	115,996
Employee Benefit	-	445	(445)	-
Capital outlay	-	-	-	1,384
Total park maintenance	137,300	141,550	(4,250)	151,184

(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, 2012
With comparative totals for the year ended September 30, 2011

	2012			2011
	Final Budget	Actual	Variance Positive (Negative)	Actual
EXPENDITURES - (CONTINUED)				
Public works - (continued)				
Streets				
Salaries and wages	$ 35,870	$ 2,758	$ 33,112	$ -
Tools and supplies	8,000	5,938	2,062	10,927
Chemicals	3,000	3,203	(203)	-
Clothing	200	12	188	-
Maintenance - radios	100	-	100	-
Reconstruction materials	25,000	31,374	(6,374)	39,544
Pipe and culverts	10,000	1,188	8,812	7,821
Electricity	60,000	45,156	14,844	45,482
Special services	17,900	23,269	(5,369)	7,809
Social security tax	2,750	164	2,586	-
Employee benefits	16,360	4,879	11,481	5,594
Capital outlay	119,000	125,188	(6,188)	93,467
Total streets	298,180	243,129	55,051	210,644
Total public works	435,480	384,679	50,801	361,828
Health and welfare				
Animal control				
Supplies	3,600	8,425	(4,825)	3,942
Telephone	800	822	(22)	929
Electricity	1,200	1,590	(390)	1,112
Special services	1,140	7,220	(6,080)	1,042
Travel, training, and dues	200	491	(291)	12
Capital outlay	-	519	(519)	-
Total animal control	6,940	19,067	(12,127)	7,037
Recycling center				
Salaries and wages	22,690	26,004	(3,314)	23,506
Tools and supplies	1,300	1,775	(475)	1,720
Telephone	700	653	47	757
Electricity	1,100	809	291	941
Special services	2,000	9,137	(7,137)	1,869
Travel, training, and dues	950	910	40	933
Social security tax	1,740	1,930	(190)	1,817
Employee benefits	11,660	11,449	211	10,007
Total recycling center	42,140	52,667	(10,527)	41,550
Total health and welfare	49,080	71,734	(22,654)	48,587

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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, 2012
With comparative totals for the year ended September 30, 2011

	2012			2011
	Final Budget	Actual	Variance Positive (Negative)	Actual
EXPENDITURES - (CONTINUED)				
Special services				
Unemployment	$ 5,000	$ 2,403	$ 2,597	$ 21,377
Note principal	-	-	-	35,800
Note interest	-	-	-	11,811
Hospital assistance	10,000	10,000	-	10,000
Development agreement rebate	73,900	32,785	41,115	50,017
Insurance and bonds	70,000	70,583	(583)	70,037
Community improvements	7,000	2,014	4,986	1,290
Total special services	165,900	117,785	48,115	200,332
Total expenditures	2,359,370	2,377,720	(18,350)	2,262,557
Excess (deficiency) of revenues over expenditures	(294,300)	(181,703)	112,597	(173,176)
OTHER FINANCING SOURCES (USES)				
Transfers in	424,560	422,280	(2,280)	422,280
Transfers out	(70,000)	(193,389)	(123,389)	(70,000)
Total other financing sources (uses)	354,560	228,891	(125,669)	352,280
Net change in fund balance	60,260	47,188	(13,072)	179,104
Fund balance at beginning of year	560,978	560,978	-	381,874
Fund balance at end of year	$ 621,238	$ 608,166	$ (13,072)	$ 560,978

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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, 2012
With comparative totals for September 30, 2011

	2012	2011
ASSETS		
Current assets		
Cash and cash equivalents	$ 3,263,951	$ 3,837,366
Receivables		
Accounts	487,341	486,656
Other	158,134	800
Allowance for uncollectible accounts	(176,465)	(170,796)
Due from other funds	-	4,025
Inventory	104,574	54,063
Total current assets	3,837,535	4,212,114
Noncurrent assets		
Capital assets		
Office equipment and furniture	47,715	47,715
Machinery and equipment	453,503	496,031
Service delivery system	17,284,510	16,961,369
Buildings and fixtures	3,404,639	3,404,639
Land structured facilities	760,184	760,184
Total capital assets	21,950,551	21,669,938
Accumulated depreciation	(7,922,920)	(7,399,365)
Subtotal	14,027,631	14,270,573
Land	8,129	7,373
Construction in progress	489,966	168,968
Net capital assets	14,525,726	14,446,914
Deferred expenses (net)	142,255	158,911
Total noncurrent capital assets	14,667,981	14,605,825
Total assets	18,505,516	18,817,939
LIABILITIES		
Current liabilities		
Accounts payable	79,719	166,177
Accrued expenses	8,870	5,654
Due to other funds	290,001	275,643
Accrued interest payable	17,841	110,320
Customer meter deposits	113,755	110,945
Accrued compensated absences	609	6,328
Current portion of payable to developer	35,000	75,000
Current portion of general obligation bonds	140,000	140,000
Total current liabilities	685,795	890,067
Noncurrent liabilities		
General obligation bonds	145,000	285,000
Certificates of obligation	3,654,517	3,654,517
Payable to developer	1,133,163	1,125,948
Total noncurrent liabilities	4,932,680	5,065,465
Total liabilities	5,618,475	5,955,532
NET ASSETS		
Invested in capital assets, net of related debt	12,823,460	12,739,751
Unrestricted net assets	63,581	122,656
Total net assets	$ 12,887,041	$ 12,862,407

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, 2012

With comparative totals for the year ended September 30, 2011

	2012	2011
OPERATING REVENUES		
Charges for services	$ 2,272,148	$ 2,241,745
OPERATING EXPENSES		
Water system	704,389	663,556
Sanitary sewer system	243,102	292,580
Solid waste	602,031	613,394
Miscellaneous	17,893	16,623
Depreciation	566,084	550,885
Amortization	4,512	4,512
Total operating expenses	2,138,011	2,141,550
Operating income (loss) before nonoperating revenues (expenses) and contributions and transfers	134,137	100,195
NONOPERATING REVENUES (EXPENSES)		
Investment income		
Interest	4,589	2,878
Connection fees	18,175	8,500
Miscellaneous income (expense)	2,574	10,634
Interest and fiscal charges	(119,804)	(129,077)
Total nonoperating revenues (expenses)	(94,466)	(107,065)
Income (loss) before contributions and transfers	39,671	(6,870)
Contributions and transfers		
Capital contributions	555,490	115,110
Transfers out	(570,529)	(522,500)
Total contributions and transfers	(15,039)	(407,390)
Change in net assets	24,632	(414,260)
Total net assets at beginning of year	12,862,409	13,276,667
Total net assets at end of year	$ 12,887,041	$ 12,862,407

CITY OF PALACIOS, TEXAS
MAJOR ENTERPRISE FUND - AIRPORT FUND
STATEMENT OF NET ASSETS
September 30, 2012
With comparative totals for September 30, 2011

	2012	2011
ASSETS		
Current assets		
Cash and cash equivalents	$ 103,800	$ 103,776
Accounts receivable	575	450
Inventory	29,720	22,944
Total current assets	134,095	127,170
Noncurrent assets		
Capital assets		
Machinery and equipment	70,462	80,893
Buildings and fixtures	117,979	66,479
Land structured facilities	1,394,215	524,577
Total capital assets	1,582,656	671,949
Accumulated depreciation	(343,886)	(314,620)
Subtotal	1,238,770	357,329
Construction in progress	-	-
Net capital assets	1,238,770	357,329
Total assets	1,372,865	484,499
LIABILITIES		
Accounts payable	809	2,191
Due to other funds	108,401	33,533
Total liabilities	109,210	35,724
NET ASSETS		
Invested in capital assets	1,238,770	357,329
Unrestricted net assets	24,885	91,446
Total net assets	$ 1,263,655	$ 448,775

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, 2012
With comparative totals for the year ended September 30, 2011

	2012	2011
OPERATING REVENUES		
Charges for services	$ 18,001	$ 29,969
Rental income	30,042	30,615
Total operating revenues	48,043	60,584
OPERATING EXPENSES		
Airport expenses		
Supplies	17,730	26,260
Repairs and maintenance	2,740	1,151
Utilities	9,399	11,268
Insurance and bonds	13,725	13,981
Special items	19,136	14,396
Depreciation	39,697	15,706
Total operating expenses	102,427	82,762
Operating income (loss) before nonoperating revenues (expenses) and transfers	(54,384)	(22,178)
NONOPERATING REVENUES (EXPENSES)		
Investment income		
Interest	124	150
Miscellaneous income (expense)	6,097	69
Nonoperating lease income	23,637	23,637
Total nonoperating revenues (expenses)	29,858	23,856
Income (loss) before transfers	(24,526)	1,678
Transfers		
Transfer out	(54,780)	(54,780)
Total transfers	(54,780)	(54,780)
Change in net assets	(79,306)	(53,102)
Total net assets at beginning of year	1,342,961	501,877
Total net assets at end of year	$ 1,263,655	$ 448,775

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OVERALL COMPLIANCE AND INTERNAL CONTROL SECTION

Baker, Stogner & Associates
Certified Public Accountants

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El Campo, TX 77437

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(979) 543-6668 Fax

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, 2012, which collectively comprise the City's basic financial statements and have issued our report thereon dated February 28, 2013. 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.*

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.

Baker, Stogner & Associates

February 28, 2013