HESPERIA WATER DISTRICT

COMPONENT UNIT FINANCIAL STATEMENTS

WITH REPORT ON AUDIT BY
INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

June 30, 2011

June 30, 2011

WHITE NELSON DIEHL EVANS LLP
Certified Public Accountants & Consultants

INDEPENDENT AUDITORS' REPORT

The Board of Directors
Hesperia Water District
Hesperia, California

We have audited the accompanying basic financial statements of the Hesperia Water District (a component unit of the City of Hesperia) as of and for the year ended June 30, 2011, as listed in the table of contents. These component unit financial statements are the responsibility of the District's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the State Controller's Minimum Audit Requirements for California Special Districts. 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the District's internal control over financial reporting. Accordingly, we express no such opinion. 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 the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the component unit financial statements referred to above present fairly, in all material respects, the respective financial position of the Hesperia Water District as of June 30, 2011, and the changes in financial position and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America, as well as the accounting systems prescribed by the State Controller's Office and State regulations governing Special Districts.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis and the schedule of funding progress for DPHP, as listed in the accompanying table of contents as required supplementary information be presented to supplement the basic financial statements. Such information, although not a part of the required 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 management's discussion and analysis and the schedule of funding progress 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,

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the basic financial statements, and other knowledge we obtained during the audit of the basic financial statements. We do not express an opinion or provide any assurance on the management's discussion and analysis and the schedule of funding progress because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

White Nelson Diehl Evans LLP

January 16, 2012
Carlsbad, California

MANAGEMENT'S DISCUSSION AND ANALYSIS

Our discussion and analysis of the Hesperia Water District's financial performance provides an overview of the District's financial activities for the fiscal year ended June 30, 2011. Please read it in conjunction with the accompanying basic financial statements.

FINANCIAL HIGHLIGHTS

- The District's net assets decreased roughly $2.5 million from $80.2 million to $77.7 million or 3.1% as a result of this year's operations. This is primarily the result of $1.4 million of water purchases and a $0.5 million increase of wastewater treatment costs from the regional wastewater JPA which are passed on to the District's sewer customers.

- During the year, the District's expenses exceeded revenues and contributions by $2.5 million, in spite of an increase in operating revenues of $1.1 million. During FY 2010-11, 0 single family residential permits were issued as compared to the FY 2009-10 total of 3 permits, FY 2008-09 total of 12 permits, and FY 2007-08 total of 106 permits.

- The total cost of the District's operations and capital improvements was $22.6 million, which is a increase of 6.3% from the June 2010's total of $21.3 million. This increase of expenses is largely due to the previously mentioned expiration of prepaid water purchases and the increase in sewer operating costs.

USING THIS ANNUAL REPORT

This annual report consists of a series of financial statements. The Statement of Net Assets provides information about the activities of the District as a whole and with the water and sewer functions separately. Also, it presents a longer-term view of the District's finances. The Statement of Revenues, Expenses, and Changes in Net Assets describes how these services were financed in the short term as well as what remains for future spending. The remaining statement, The Statement of Cash Flows, provides financial information about cash flow activities of the District.

REPORTING THE DISTRICT AS A WHOLE

The financial statements presented herein include all the activities of the Hesperia Water District using the integrated approach as prescribed by GASB Statement No. 34.

One of the most important questions asked about the District's finances is, "Is the District as a whole better off or worse off as a result of this year's activities?" The Statement of Net Assets reports information about the District as a whole and about its activities in a way that helps answer this question. This statement includes *all* assets and liabilities using the *accrual basis of accounting*, which is similar to the accounting used by most private-sector companies. All of the current year's revenues and expenses are taken into account regardless of when cash is received or paid.

The statement reports the District's *net assets*. You can think of the District's net assets—the difference between assets and liabilities—as one way to measure the District's financial health, or *financial position*. Over time, *increases or decreases* in the District's net assets are one indicator of whether its *financial health* is improving or deteriorating. You will need to consider other nonfinancial factors, however, such as the condition of the District's water lines, to assess the *overall health* of the District.

THE DISTRICT AS A WHOLE

Our analysis focuses on the net assets (Table 1) and changes in net assets (Table 2) of the District. In prior years, more than ten years ago, the District incurred debt to build some of the infrastructure. The Condensed Statement of Net Assets presents capital assets net of the debt incurred to pay for those assets.

The current year saw net assets decrease from $80.2 million to $77.7 million. This decrease of roughly $2.5 million comes from the change in net assets as recorded in the Condensed Statement of Revenues, Expenses, and Changes in Net Assets and flows through the Condensed Statement of Net Assets. The Water District continues to maintain the water and sewer infrastructure which includes water storage tanks, water pumping equipment, water transmission lines, and sewer lines, etc.

Table 1

Condensed Statement of Net Assets

			Changes from 2010 to 2011	
	2010	2011	Amount	Percentage
Current and other assets	$ 20,257,530	$ 19,612,075	$ (645,455)	-3.2%
Capital assets	92,751,289	90,334,079	(2,417,210)	-2.6%
Total Assets	113,008,819	109,946,154	(3,062,665)	-2.7%
Other liabilities	12,730,475	13,956,555	1,226,080	9.6%
Long-term debt outstanding	20,125,262	18,323,916	(1,801,346)	-9.0%
Total Liabilities	32,855,737	32,280,471	(575,266)	-1.8%
Net Assets:				
Invested in capital assets, net of debt	72,865,322	77,118,870	4,253,548	5.8%
Restricted	1,890,305	1,890,305	-	0.0%
Unrestricted	5,397,455	(1,343,492)	(6,740,947)	-124.9%
Total Net Assets	$ 80,153,082	$ 77,665,683	$ (2,487,399)	-3.1%

The following is a list of explanations for the $2.5 million decrease in net assets:

- Current and other assets – decreased by $0.6 million or 3.2% from June 30, 2010. The decrease is considered minor and is primarily due to the repayment of $1.2 million of a $6.0 million loan from the Hesperia Community Redevelopment Agency (HCRA).

- Capital assets – decreased by $2.4 million, net of depreciation, over June 30, 2010 principally from the accumulated depreciation of the assets currently in use.

- Other liabilities – increased $1.2 million from June 30, 2010 which is primarily due to a net increase of $1.4 million to the Due To/Due From account for an advancement of funding from the sewer fund to the water fund, which increased the outstanding liabilities; and a $0.2 million decrease due to the change of the Derivative Instruments valuation, which shows a liability reduction from $2.6 million for June 30, 2010 to $2.4 million for June 30, 2011 for the fair value of the interest rate swap agreement of $10.0 million in connection with the issuance of the $18.0 million Variable Rate Lease Revenue Refunding Bonds, Taxable Series 1998A.

- Long-term debt outstanding – debt service activity during the fiscal year resulted in a net decrease of $1.8 million from June 30, 2010. The decrease is primarily due to the repayment of

$1.2 million of a $6.0 million loan from the HCRA and $0.8 million decrease from principal payments on outstanding debt, as shown in Table 4.

- Invested in capital assets, net of related debt – increased by $4.3 million, or 5.8%, over the year ended June 30, 2010, which is due to changing the calculation of the debt owed to the HCRA from invested in capital assets to unrestricted net assets.

- Restricted net assets – no change was made from June 30, 2010.

- Unrestricted net assets – decreased by $6.7 million or 124.9% primarily due to the $4.8 million loan payable in 2010 that was classified as Invented in Capital Assets Net of Related Debt instead of Unrestricted Net Assets.

DISTRICT ACTIVITIES

The District's net assets decreased $2.5 million or 3.1%. The cost of all Water District activities this year was $22.6 million which is about $1.3 million less than the $21.3 million from the prior year. As shown in the Condensed Statement of Revenues, Expenses, and Changes in Net Assets (Table 2), the amount paid by users of the systems was $19.1 million, which is an increase of $1.1 million or 6.3% from the June 30, 2010 total of $18.0 million. The increase is attributed to the 4% water rate and a 7% sewer rate increase which became effective on November 1, 2010. Non-operating revenues of $1.0 million make up the remainder of the $20.1 million total revenues.

Table 2

Condensed Statement of Revenues, Expenses, and Changes in Net Assets

	2010	2011	Changes from 2010 to 2011 Amount	Percentage
Revenues				
Operating revenues:				
Charges for services	$ 17,993,175	$ 19,134,211	$ 1,141,036	6.3%
Non-operating revenues:				
Property taxes	247,343	262,581	15,238	6.2%
Interest income	36,712	130,657	93,945	255.9%
System improvement and replacement	498,973	187,560	(311,413)	-62.4%
Rent income	402,320	406,340	4,020	1.0%
Sub-total non-operating revenues	1,185,348	987,138	(198,210)	-16.7%
Total revenues	19,178,523	20,121,349	942,826	4.9%
Expenses				
Water	19,121,036	19,928,163	807,127	4.2%
Wastewater	2,147,458	2,680,585	533,127	24.8%
Total expenses	21,268,494	22,608,748	1,340,254	6.3%
Change in net assets	(2,089,971)	(2,487,399)	(397,428)	49.2%
Net assets at July 1,	82,243,053	80,153,082	(2,089,971)	-2.5%
Net assets at June 30,	$ 80,153,082	$ 77,665,683	$ (2,487,399)	-3.1%

Non-operating revenues decreased $0.2 million in FY 2010-11 largely due to a $0.3 million decrease in capital facility and capital surcharge revenues. The capital facility and capital surcharge revenues are primarily a reflection of the development activity occurring in Hesperia and are mostly attributable to offsetting the costs of adding the customers to the system. As seen in the above table, this revenue group reflects the continued decrease of the development activity within the City of Hesperia which saw a decrease in single family residential permits issued from 12 in FY 2008-09 to 3 for FY 2009-10 to 0 for FY 2010-11.

The District's total expenses increased approximately $1.3 million or 6.3% in FY 2010-11. This increase is largely a result of the $1.4 million recognition of water costs in FY 2010-11, and a $0.5 million increase in wastewater expenses in large part due to increased wastewater treatment fees.

CAPITAL ASSETS

The capital assets of the District are those assets that are used in the performance of the District's functions including infrastructure assets. At June 30, 2011, capital assets, net of depreciation, totaled $90.3 million reflecting a decrease of $2.4 million net of depreciation.

Table 3
Capital Assets at Year-End

	Balance at June 30, 2010 Net of Accumulated Depreciation	Increases	Decreases	Current Year Depreciation	Balance at June 30, 2011 Net of Accumulated Depreciation
Land	$ 3,174,528	$ -	$ -	$ -	$ 3,174,528
Water rights	1,699,000	-	-	-	1,699,000
Land improvements	241,538	-	-	(20,877)	220,661
Vehicles	998,107	-	-	(203,683)	794,424
Building and structures	1,982,875	-	-	(239,560)	1,743,315
Machinery and equipment	794,639	7,384	-	(165,776)	636,247
Infrastructure:					
Water facilities	78,812,367	-	-	(2,969,309)	75,843,058
Sewer facilities	4,149,115	-	-	(178,951)	3,970,164
Construction in progress	899,120	1,353,562	-	-	2,252,682
	$ 92,751,289	$ 1,360,946	$ -	$ (3,778,156)	$ 90,334,079

The District has elected to use the "Basic Approach" as defined by GASB Statement No. 34 for infrastructure reporting for water lines. Using the "Basic Approach," the District will depreciate the value of the infrastructure over a forty (40) year period. As replacing of water line segments is done, the value of that work will be added and any remaining book value of the replaced segment will be reduced from the water facilities infrastructure class. The District's other capital assets are depreciated as outlined in Note 1 paragraph L.

DEBT ADMINISTRATION

Debt issued by the Hesperia Water District is not the responsibility of the City of Hesperia, in like manner; the debt issued by the City of Hesperia is not the responsibility of the Hesperia Water District. Debt of the Hesperia Water District decreased by a net amount of $1.8 million in FY 2010-11. The decrease is largely due to an annual scheduled payment of $1.2 million on a 5-year $6.0 million loan from the Hesperia Community Redevelopment Agency and $0.7 million decrease from scheduled revenue bond payments. Table 4, below, presents the outstanding debt.

Table 4
Outstanding Debt at Year-End

	Principal Balance at June 30, 2010	Additions	Deductions	Principal Balance at June 30, 2011
Loans	$ 6,000,000	$ -	$ (1,200,000)	$ 4,800,000
Certificates of participation	990,000	-	(50,000)	940,000
Revenue bonds	14,205,000	-	(705,000)	13,500,000
Less deferred amounts:				
Bond discounts	(113,436)	-	7,305	(106,131)
On refunding	(1,195,597)	-	76,937	(1,118,660)
Compensated absences	172,523	156,454	(153,432)	175,545
Claims payable	66,772	252,802	(186,412)	133,162
	$ 20,125,262	$ 409,256	$ (2,210,602)	$ 18,323,916

ECONOMIC FACTORS AND NEXT YEAR'S BUDGETS AND RATES

During the 2007-08 fiscal year the Board approved a series of water rate increases over a five year period starting with FY 2007-08. The overall water rate increase for the first three years is 9% followed by two years of 4%. In addition, the Board approved sewer rate increases of 7% for all five years. The water rate increase for FY 2011-12 will be 4%, while the sewer rate increase will be 7%.

As detailed in the FY 2011-12 Budget, the District will not make any planned expenses related to capital improvement.

CONTACTING THE DISTRICT'S FINANCIAL MANAGEMENT

This financial report is designed to provide our citizens, taxpayers, customers, investors, and creditors with a general overview of the District's finances and to show the District's accountability for the money it receives. If you have questions about this report or need additional financial information, contact the District's Finance Division, at the Hesperia Water District, 9700 Seventh Avenue, Hesperia, California 92345.

STATEMENT OF NET ASSETS
June 30, 2011

	Water Operations & Capital	Sewer Operations & Capital	Total
ASSETS			
Current Assets:			
Cash and cash equivalents	$ -	$ 1,177,373	$ 1,177,373
Receivables:			
Accounts	2,709,673	523,515	3,233,188
Accrued interest	873	1,419	2,292
Deposits	22,284	3,317	25,601
Inventories	1,261,998	-	1,261,998
Due from other funds	-	8,117,068	8,117,068
Due from other governmental agencies	20,633	10,783	31,416
Deferred asset from derivative instrument	2,357,194	-	2,357,194
Restricted Assets:			
Cash and investments with fiscal agent	1,890,305	-	1,890,305
Cash held for bondholders	393,285	-	393,285
Total Current Assets	8,656,245	9,833,475	18,489,720
Noncurrent Assets:			
Other Noncurrent Assets:			
Prepaid expenses	497,600	-	497,600
Deferred charges	263,801	-	263,801
Deposits for self-insurance	329,449	31,505	360,954
Total Other Noncurrent Assets	1,090,850	31,505	1,122,355
Capital Assets:			
Land	1,371,741	1,802,787	3,174,528
Water rights	1,699,000	-	1,699,000
Construction in progress	2,252,682	-	2,252,682
Land improvements	790,727	-	790,727
Vehicles	2,271,302	75,819	2,347,121
Machinery and equipment	3,965,985	265,768	4,231,753
Buildings and improvements	7,889,838	-	7,889,838
Water and sewer facilities	117,408,505	7,137,408	124,545,913
Less: Accumulated depreciation	(53,248,451)	(3,349,032)	(56,597,483)
Total Capital Assets	84,401,329	5,932,750	90,334,079
Total Noncurrent Assets	85,492,179	5,964,255	91,456,434
Total Assets	$ 94,148,424	$ 15,797,730	$ 109,946,154

See accompanying independent auditors' report and notes to basic financial statements.

LIABILITIES	Water Operations & Capital	Sewer Operations & Capital	Total
Current Liabilities:			
Accounts payable	$ 1,890,587	$ 230,514	$ 2,121,101
Accrued personnel costs	134,478	7,685	142,163
Accrued interest payable	57,755	-	57,755
Deposits	506,189	-	506,189
Due to other funds	8,117,068	-	8,117,068
Current liabilities payable from restricted assets - due to bondholders	393,285	-	393,285
Liability from derivative instrument	2,357,194	-	2,357,194
Long term debt due within one year	2,130,031	23,492	2,153,523
Total Current Liabilities	15,586,587	261,691	15,848,278
Noncurrent Liabilities:			
Net OPEB obligation	261,800	-	261,800
Compensated absences	6,043	979	7,022
Claims payable	120,063	13,099	133,162
Loan payable	3,600,000	-	3,600,000
Revenue bonds (net of unamortized discounts and deferred amounts on refunding)	11,545,209	-	11,545,209
Certificates of participation	885,000	-	885,000
Total Noncurrent Liabilities	16,418,115	14,078	16,432,193
Total Liabilities	32,004,702	275,769	32,280,471
NET ASSETS			
Invested in capital assets, net of related debt	71,186,120	5,932,750	77,118,870
Restricted for debt service	1,890,305	-	1,890,305
Unrestricted	(10,932,703)	9,589,211	(1,343,492)
Total Net Assets	$ 62,143,722	$ 15,521,961	$ 77,665,683

See accompanying independent auditors' report and notes to basic financial statements.

STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
For the Year Ended June 30, 2011

	Water Operations & Capital	Sewer Operations & Capital	Total
OPERATING REVENUES			
Water sales	$ 15,359,282	$ -	$ 15,359,282
Water services	247,606	-	247,606
Sewer services	-	3,207,605	3,207,605
Other	319,718	-	319,718
Total Operating Revenues	15,926,606	3,207,605	19,134,211
OPERATING EXPENSES			
General and administrative	7,576,566	-	7,576,566
Engineering	919,460	-	919,460
Production	3,085,362	-	3,085,362
Distribution	1,132,399	2,473,108	3,605,507
Customer service	2,797,816	-	2,797,816
Depreciation and amortization	3,588,593	207,477	3,796,070
Total Operating Expenses	19,100,196	2,680,585	21,780,781
OPERATING INCOME (LOSS)	(3,173,590)	527,020	(2,646,570)
NON-OPERATING REVENUES (EXPENSES)			
Unrestricted system improvement and replacement	187,560	-	187,560
Property taxes	261,549	-	261,549
Property taxes - debt service	1,032	-	1,032
Rent income	406,340	-	406,340
Interest income	14,275	116,382	130,657
Interest expense	(827,967)	-	(827,967)
Total Non-Operating Revenues (Expenses), Net	42,789	116,382	159,171
Change In Net Assets	(3,130,801)	643,402	(2,487,399)
Net assets at beginning of year	65,274,523	14,878,559	80,153,082
Net assets at end of year	$ 62,143,722	$ 15,521,961	$ 77,665,683

See accompanying independent auditors' report and notes to basic financial statements.

STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2011

	Water Operations & Capital	Sewer Operations & Capital	Total
Cash Flows from Operating Activities:			
Cash received from water and sewer customers	$ 15,578,716	$ 3,180,205	$ 18,758,921
Cash received from other operating receipts	319,718	-	319,718
Cash payments for water purchases	(5,528,363)	-	(5,528,363)
Cash payments for sewer collection and maintenance	-	(2,863,775)	(2,863,775)
Cash payments for services and supplies	(1,164,865)	-	(1,164,865)
Cash payments to employees for services	(7,419,371)	-	(7,419,371)
Net Cash Provided (Used) by Operating Activities	1,785,835	316,430	2,102,265
Cash Flows from Noncapital and Related Financing Activities:			
Property taxes received	262,581	-	262,581
Advances from/to other funds	1,401,569	(1,401,569)	-
Net Cash Provided (Used) by Noncapital and Related Financing Activities	1,664,150	(1,401,569)	262,581
Cash Flows from Capital and Related Financing Activities:			
Acquisition and construction of capital assets	(1,360,946)	-	(1,360,946)
Unrestricted system improvement and replacement receipts	187,560	-	187,560
Advance to VVWRA	-	(326,919)	(326,919)
Repayment of advance to VVWRA	-	1,904,017	1,904,017
Interest received from advances	-	103,464	103,464
Cash received from bondholders	2,528	-	2,528
Cash payment on loan payable to HCRA	(1,200,000)	-	(1,200,000)
Interest payments on long-term debt	(744,365)	-	(744,365)
Principal payments on long-term debt	(755,000)	-	(755,000)
Net Cash Provided (Used) by Capital and Related Financing Activities	(3,870,223)	1,680,562	(2,189,661)
Cash Flows from Investing Activities:			
Rents received	406,340	-	406,340
Interest received	16,426	45,439	61,865
Net Cash Provided by Investing Activities	422,766	45,439	468,205
Net Increase (Decrease) in Cash and Cash Equivalents	2,528	640,862	643,390
Cash and cash equivalents at beginning of year	2,281,062	536,511	2,817,573
Cash and cash equivalents at end of year	$ 2,283,590	$ 1,177,373	$ 3,460,963

(continued)

See accompanying independent auditors' report and notes to basic financial statements.

(continued)

STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2011

	Water Operations & Capital	Sewer Operations & Capital	Total
Reconciliation of Operating Income to Net Cash Flows Provided by Operating Activities:			
Operating income (Loss)	$ (3,173,590)	$ 527,020	$ (2,646,570)
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities:			
Depreciation and amortization	3,588,593	207,477	3,796,070
Changes in operating assets and liabilities:			
(Increase) decrease in accounts receivable	(28,172)	(36,057)	(64,229)
(Increase) decrease in deposits	89,846	10,485	100,331
(Increase) decrease in inventory	728,019	-	728,019
(Increase) decrease in due from other governments	6,559	9,367	15,926
Increase (decrease) in accounts payable	522,077	(366,434)	155,643
Increase (decrease) in accrued personnel costs	(5,236)	(710)	(5,946)
Increase (decrease) in customer deposits	(53,918)	(3,543)	(57,461)
Increase (decrease) in net OPEB obligation	105,300	-	105,300
Increase (decrease) in deferred revenue	-	(27,840)	(27,840)
Increase (decrease) in compensated absences	6,357	(3,335)	3,022
Total Adjustments	4,959,425	(210,590)	4,748,835
Net Cash Provided (Used) by Operating Activities	$ 1,785,835	$ 316,430	$ 2,102,265

Supplemental Disclosures:

	Water Operations & Capital		
Noncash Capital and Financing Activities			
Amortization Related to Long-Term Debt	$ 84,242		

See accompanying independent auditors' report and notes to basic financial statements.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

The accounting policies of the Hesperia Water District (the District) conform to generally accepted accounting principles as applicable to governmental units. The following is a summary of the more significant policies:

a. Description of Reporting Entity:

The District was organized pursuant to Section 30000 et seq. of the California Water Code. The District has two main areas of responsibility that are as follows:

Water Operations & Capital - The Water Division's main objective is to deliver and ensure adequate supplies of water. The water is to meet all drinking water quality regulations and to maintain District Facilities to ensure unobstructed flows during water runoff.

Sewer Operations & Capital - The Sewer Division's main objective is to transmit and ensure continuous unobstructed flows of sewage to the regional plant.

The District is an integral part of the reporting entity of the City of Hesperia (the City). The accounts of the District have been included within the scope of the basic financial statements of the City because the City Council has financial accountability over the operations of the District. Only the accounts of the District are included herein, therefore, these financial statements do not purport to represent the financial position or results of operations of the City of Hesperia.

b. Basic Financial Statements:

The basic financial statements are comprised of the Statement of Net Assets, the Statement of Revenues, Expenses, and Changes in Net Assets, the Statement of Cash Flows and the Notes to Basic Financial Statements.

c. Basis of Presentation:

The District reports its activities as an enterprise fund, which is used to account for operations that are financed and operated in a manner similar to a private business enterprise, where the intent of the District is that the costs (including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges. Revenues and expenses are recognized on the accrual basis. Revenues are recognized in the accounting period in which they are earned and expenses are recognized in the period incurred.

The District has elected to apply all applicable Governmental Accounting Standards Board (GASB) pronouncements as well as any applicable pronouncements of the Financial Accounting Standards Board (FASB), the Accounting Principles Board (APB), or any Accounting Research Bulletins (ARB) issued on or before November 30, 1989, unless they contradict or conflict with GASB pronouncements. The District has opted not to apply Financial Accounting Standards Board (FASB) Statements and Interpretations issued after November 30, 1989.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued):

d. Measurement Focus and Basis of Accounting:

Measurement focus is a term used to describe “which” transactions are recorded within the various financial statements. Basis of accounting refers to “when” transactions are recorded regardless of the measurement focus applied. The accompanying financial statements are reported using the “economic resources measurement focus”, and the “accrual basis of accounting”. The accounting objectives of economic measurement focus are the determination of operating income, changes in net assets (or cost recovery), financial position and cash flows. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows.

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

The District distinguishes operating revenues and expenses from those revenues and expenses that are non-operating. Operating revenues are those revenues that are generated by water sales and sewer services while operating expenses pertain directly to the furnishing of those sales and services. Non-operating revenues and expenses are those revenues and expenses generated that are not directly associated with the normal business of supplying water and sewer services.

e. Net Assets:

In the Statement of Net Assets, net assets are classified in the following categories:

- Invested in capital assets, net of related debt - This amount consists of capital assets net of accumulated depreciation and reduced by outstanding debt that is attributed to the acquisition, construction, or improvement of the assets.
- Restricted net assets – This amount is restricted by external creditors, grantors, contributors, or laws or regulations of other governments or constraints imposed by law through constitutional provisions or enabling legislation.
- Unrestricted net assets – This amount is all net assets that do not meet the definition of “invested in capital assets, net of related debt” or “restricted net assets”.

f. Inventories:

Inventories consist of materials and supplies that are valued at cost and are recorded as expenses on a first-in, first-out basis when consumed.

g. Compensated Absences:

A liability is recorded for unused vacation and similar compensatory leave balances since the employees' entitlement to these balances are attributable to services already rendered and it is probable that virtually all of these balances will be liquidated by either paid time off or payments upon termination or retirement.

Vacation pay is payable to employees at the time vacation is taken or upon termination of employment. Normally, an employee cannot accrue more than 160 hours during a one year accrual period.

Sick leave is payable when an employee is unable to work because of illness. Upon termination, any unused sick leave will not be paid.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued):

h. Unbilled Services:

Unbilled water revenue of the enterprise fund is recognized as earned when the water is consumed.

i. Use of Estimates:

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

j. Property Taxes:

Property tax in California is levied in accordance with Article 13A of the State Constitution at one percent of county-wide assessed valuations. This levy is allocated pursuant to state law to the appropriate units of local government.

Property tax revenue is recognized in the fiscal year in which they have been levied.

The property tax calendar is as follows:

Lien Date:	January 1
Levy Date:	July 1
Due Date:	First Installment - November 10
	Second Installment - February 10
Delinquent Date:	First Installment - December 11
	Second Installment - April 11

k. Cash and Investments:

Investments are stated at fair value (quoted market price or best available estimate thereof, see Note 2).

l. Capital Assets and Depreciation:

Capital Assets are stated at cost or estimated historical cost. Contributed fixed assets are recorded at estimated fair market value at the time received. Net interest costs are capitalized on projects during the construction period. The District's capitalization policy sets the threshold for reporting capital assets at $5,000.

Depreciation is charged using the straight-line method based on the estimated useful life of the related asset. The estimated useful life of the assets are as follows:

Buildings	30 years
Improvements	20 years
Machinery and equipment	5-30 years
Vehicles	8 Years
Water and sewer facilities	40 years

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued):

m. Statement of Cash Flows:

For purposes of the statement of cash flows, the District considers all highly liquid investments with an original maturity of three months or less when purchased and all amounts invested in a cash and investment pool to be cash equivalents.

n. Claims and Judgments and Self-Insurance Program:

When it is probable that a claim liability has been incurred at year end, and the amount of the loss can be reasonably estimated, the District records the estimated loss, net of any insurance coverage under its self-insurance program. At June 30, 2011, in the opinion of the District's Attorney, the District had no material unrecorded claims which would require loss provision in the financial statements, including losses for claims which are Incurred But Not Reported (IBNR). Small dollar claims and judgments are recorded as expenses when paid.

The District participates in the self-insurance program of the City of Hesperia. Information relating to the self-insurance program is available in the City of Hesperia Comprehensive Annual Financial Report.

o. Accounts Receivable and Allowances:

Accounts receivable are recorded at the invoiced amount. The District maintains an allowance for doubtful accounts. The allowance for doubtful accounts is based on the best estimate of the amount of probable future credit losses in existing accounts receivable. The District reviews the allowance for doubtful accounts on an annual basis. There was no allowance for doubtful accounts at June 30, 2011.

2. CASH, CASH EQUIVALENTS, AND INVESTMENTS:

Cash and investments at June 30, 2011 are classified in the accompanying financial statements as follows:

STATEMENT OF NET ASSETS:		
Current Assets:		
Cash and cash equvalents	$	1,177,373
Restricted assets:		
Cash and investments with fiscal agent		1,890,305
Cash held for bondholders		393,285
Total cash and investments	$	3,460,963

See accompanying independent auditors' report.

2. CASH, CASH EQUIVALENTS, AND INVESTMENTS (Continued):

Investments Authorized by the California Government Code and the District's Investment Policy:

The table below identifies the investment types that are authorized for the District by the California Government Code (or the District's investment policy, where more restrictive). The table also identifies certain provisions of the California Government Code (or the District's investment policy, where more restrictive) that address interest rate risk, credit risk, and concentration of credit risk. This table does not address investments of debt proceeds held by bond trustee that are governed by the provisions of debt agreements of the District's, rather than the general provisions of the California Government Code or the District's investment policy.

Authorized Investment Type	Maximum Maturity	Maximum Percentage Of Portfolio	Maximum Investment In One Issuer
U.S. Treasury Obligations	5 years	100%	None
U.S. & State or Local Agency Securities	5 years	100%	None
Banker's Acceptances	180 days	25%	5%
Commercial Paper	270 days	15%	None
Negotiable Certificates of Deposit	5 years	25%	None
Repurchase Agreements	1 years	20%	None
Local Agency Investment Fund (LAIF)	N/A	100%	None
Medium-Term Notes	5 years	30%	None
Mutual & Money Market Funds	90 days	20%	None
Collateralized Bank Deposits	5 years	10%	None
Investment Pools	N/A	30%	None
Municipal Bonds	5 years	10%	None

Investments Authorized by Debt Agreements:

Investment of debt proceeds held by the bond trustee are governed by provisions of the debt agreements, rather than the general provisions of the California Government Code or the City of Hesperia's investment policy. Investments authorized for funds held by bond trustee include, U.S. Treasury Obligations, Export-Import Bank, Federal Housing Administration Debentures, Government National Mortgage Association, U.S. Maritime Administration, U.S. Agency Securities, Money Market Funds, Certificates of Deposits, Commercial Paper, Interest Bearing Demand or Time Deposits, Banker's Acceptances, Repurchase Agreements, Repurchase Agreements Collateralized, Federal Home Loan Bank, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, Municipal Obligations, any other investment approved by the credit entity. There were no limitations on the maximum amount that can be invested in one issuer, maximum percentage allowed or the maximum maturity of an investment.

Disclosures Related to Interest Rate Risk, Credit Risk, and Custodial Credit Risk:

The District's cash and investments are pooled with the City of Hesperia's cash and investments. Additional disclosures regarding $3,460,963 in pooled investments related to interest rate risk, credit risk and custodial credit risk are available in the City of Hesperia's Comprehensive Annual Financial Report.

2. CASH, CASH EQUIVALENTS, AND INVESTMENTS (Continued):

Investment in State Investment Pool:

The District is a voluntary participant in the Local Agency Investment Fund (LAIF) that is regulated by the California Government Code under the oversight of the Treasurer of the State of California. The fair value of the District's investment in this pool is reported in the accompanying financial statements at amounts based upon the District's pro-rata share of the fair value provided by LAIF for the entire LAIF portfolio (in relation to the amortized cost of that portfolio). The balance available for withdrawal is based on the accounting records maintained by LAIF, which are recorded on an amortized cost basis.

3. ADVANCE TO VVWRA:

The District made advances to the Victor Valley Wastewater Reclamation Authority (VVWRA) totaling $1,904,017 during the fiscal years ending 6/30/2009, 6/30/2010, and 6/30/2011. The advances bear a fixed interest rate of six percent (6%) per annum. As of June 30, 2011 this advance, including interest, has been fully repaid.

4. CAPITAL ASSETS AND DEPRECIATION:

Capital asset activity for the year ended June 30, 2011 was as follows:

	Balance at June 30, 2010	Increases	Decreases	Balance at June 30, 2011
Capital assets, not being depreciated:				
Land	$ 3,174,528	$ -	$ -	$ 3,174,528
Water rights	1,699,000	-	-	1,699,000
Construction in progress	899,120	1,353,562	-	2,252,682
Total capital assets, not being depreciated	5,772,648	1,353,562	-	7,126,210
Capital assets being depreciated:				
Land improvements	790,727	-	-	790,727
Vehicles	2,347,121	-	-	2,347,121
Machinery and equipment	4,224,369	7,384	-	4,231,753
Buildings and improvements	7,889,838	-	-	7,889,838
Water facilities	117,408,505	-	-	117,408,505
Sewer facilities	7,137,408	-	-	7,137,408
Total capital assets, being depreciated	139,797,968	7,384	-	139,805,352
Less accumulated depreciation for:				
Land improvements	(549,189)	(20,877)	-	(570,066)
Vehicles	(1,349,014)	(203,683)	-	(1,552,697)
Machinery and equipment	(3,429,730)	(165,776)	-	(3,595,506)
Buildings and improvements	(5,906,963)	(239,560)	-	(6,146,523)
Water facilities	(38,596,138)	(2,969,309)	-	(41,565,447)
Sewer facilities	(2,988,293)	(178,951)	-	(3,167,244)
Total accumulated depreciation	(52,819,327)	(3,778,156)	-	(56,597,483)
Total capital assets, being depreciated,net	86,978,641	(3,770,772)	-	83,207,869
Total capital assets, net	$ 92,751,289	$ (2,417,210)	$ -	$ 90,334,079

See accompanying independent auditors' report.

5. LONG-TERM DEBT:

Following is a summary of the changes in principal balance of long-term debt for the year ended June 30, 2011:

	Principal Balance at June 30, 2010	Additions	Deductions	Principal Balance at June 30, 2011	Due Within One Year
Loans	$ 6,000,000	$ -	$ (1,200,000)	$ 4,800,000	$ 1,200,000
Certificates of Participation	990,000	-	(50,000)	940,000	55,000
Revenue Bonds	14,205,000	-	(705,000)	13,500,000	730,000
Less deferred amounts:					
Bond discounts	(113,436)	-	7,305	(106,131)	-
On refunding	(1,195,597)	-	76,937	(1,118,660)	-
Total Revenue Bonds	12,895,967	-	(620,758)	12,275,209	730,000
Compensated absences	172,523	156,454	(153,432)	175,545	168,523
Claims Payable	66,772	252,802	(186,412)	133,162	-
Total Long-term Debt	$ 20,125,262	$ 409,256	$ (2,210,602)	$ 18,323,916	$ 2,153,523

Long-term debt at June 30, 2011 is comprised of the following issues:

	Balance at June 30, 2011
2010 Loan from Hesperia Community Redevelopment Agency:	
The District was issued a 5-year loan by the Hesperia Community Redevelopment Agency on June 30, 2010, for $6,000,000 for various water capital projects. The issue bears quarterly variable interest based on the Local Agency Investment Fund Quarterly Apportionment Rate which at June 30, 2011 had a rate of 0.48%. The loan matures June 30, 2015 with annual principal payments of $1,200,000. The loan will be financed by revenues generated by the District through set rates and charges for water and sewer services.	4,800,000
1992B Certificates of Participation:	
The District issued 30-year Certificates of Participation on June 1, 1992, for $1,405,000 for the Administration Facilities Acquisition Project. The issue bears interest at a rate of 9% over its remaining life and matures through the year 2022 with principal payments ranging from $20,000 to $125,000. The Certificates will be financed by revenues generated by the District through set rates and charges for water and sewer services.	940,000

5. LONG-TERM DEBT (Continued):

1998A Variable Rate Lease Revenue Refunding Bonds:

The District issued 28-year variable rate lease revenue refunding bonds on July 2, 1998 for $18,040,000 to refund a 1991, $17,675,000 Certificate of Participation issue. The 1991 Certificate of participation is considered defeased; therefore, the issue is not included in the District's financial statements. The bonds require the District to collect gross revenues, as defined in the agreement, of at least 125% of the annual debt service of the bonds and any parity debt of the District. The District is legally required to make principal and interest payments from the net revenues of the District. The 1998A issue has an initial interest rate of 5.95%, and weekly variable rates thereafter until the fixed rate conversion date, with maturities through the year 2026, ranging from $435,000 to $1,105,000. The 1998A bonds were issued at a discount of $180,400, which is being amortized over the life of the 1998A Bonds. The difference between the reacquisition price and the net carrying value of the 1991 Certificate of Participation, $1,906,482 has been deferred and is being amortized over the remaining life of the Bonds as a component of interest expense. In June, 2004, the District entered into a variable-to-fixed-interest rate swap with Bank of America, N.A. The swap requires Bank of America, N.A. to pay the variable rate while fixing the District rate at 5.96%. The agreement provides up to $10,000,000 can be fixed at 5.96%. The amount fixed with the counterparty decreases over time to $6,910,000 at June 20, 2020. At June 30, 2011 the amount fixed was $10,000,000.	12,315,000
1998B Variable Rate Lease Revenue Refunding Bonds:	
The District issued 24-year variable rate lease revenue refunding bonds on July 2, 1998 for $2,070,000 to refund a 1992, $1,855,000 Certificate of Participation issue. The 1992A Certificate of Participation is considered defeased; therefore, the issue is not included in the District's financial statements. The bonds require the District to collect gross revenues, as defined in the agreement, of at least 125% of the annual debt service of the bonds and any parity debt of the District. The District is legally required to make principal and interest payments from the net revenues of the District. The 1998B issue has a initial interest rate of 3.95%, and weekly variable rates thereafter until the fixed rate conversion date, with maturities through the year 2022, ranging from $55,000 to $130,000. The difference between the reacquisition price and the net carrying value of the 1992A Certificate of Participation, $212,358 has been deferred and is being amortized over the remaining life of the Bonds as a component of interest expense.	1,185,000
Compensated Absences	175,545
Claims Payable	133,162
Subtotal	19,548,707
Less: Current Portion – Due Within One Year	(2,153,523)
Deferred amounts on bonds	(1,224,791)
Total Long-Term Portion of Long-Term Debt	$16,170,393

See accompanying independent auditors' report.

5. LONG-TERM DEBT (Continued):

The annual debt service requirements by year for Loans Payable are as follows:

Fiscal Year Ending	Principal	Interest	Total
2012	$ 1,200,000	$ 23,040	$ 1,223,040
2013	1,200,000	17,280	1,217,280
2014	1,200,000	11,520	1,211,520
2015	1,200,000	5,760	1,205,760
	$ 4,800,000	$ 57,600	$ 4,857,600

Variable interest rate used for the 2010 Hesperia Community Redevelopment Agency Loan was 0.48%.

The annual debt service requirements by year for Revenue Bonds are as follows:

Fiscal Year Ending	Principal	Interest	Total
2012	$ 730,000	$ 601,702	$ 1,331,702
2013	760,000	600,387	1,360,387
2014	790,000	599,015	1,389,015
2015	820,000	597,590	1,417,590
2016	855,000	572,455	1,427,455
2017-2021	4,790,000	2,153,930	6,943,930
2022-2026	4,755,000	791,333	5,546,333
	$ 13,500,000	$ 5,916,412	$ 19,416,412

Variable interest rate used for the 1998A Variable Rate Lease Revenue Refunding Bonds above the $10,000,000 fixed amounts was 0.19%. Variable interest rate used for the 1998B Variable rate Lease revenue Refunding Bonds was 0.11%.

The annual debt service requirements by year for the Certificates of Participation are as follows:

Fiscal Year Ending	Principal	Interest	Total
2012	$ 55,000	$ 84,600	$ 139,600
2013	60,000	79,650	139,650
2014	65,000	74,250	139,250
2015	70,000	68,400	138,400
2016	75,000	62,100	137,100
2017-2021	490,000	196,200	686,200
2022	125,000	11,250	136,250
	$ 940,000	$ 576,450	$ 1,516,450

6. PENSION PLAN OBLIGATIONS:

Plan Description:

The District's employees participate in the Miscellaneous 2.7% at 55 Risk Pool (Plan) of the California Public Employees' Retirement System (PERS). This plan is cost-sharing, multiple-employer defined benefit pension plan administered by PERS. PERS provides retirement and disability benefits, annual cost-of-living adjustments, and death benefits to plan members and beneficiaries. A menu of benefit provisions as well as other requirements is established by State statutes within the Public Employees' Retirement Law. The District selects optional benefit provisions from the benefit menu by contract with PERS and adopts those benefits through local ordinance. Copies of PERS' annual financial report may be obtained from the PERS Executive Office: 400 P Street, Sacramento, CA 95814.

Funding Policy:

Participants are required to contribute 8% of their annual covered salary. The employees of the District contribute 5% of the 8% contribution required of the District employees while the remaining 3% is contributed by the District on behalf of the employees. The District is required to contribute the actuarially determined remaining amounts necessary to fund the benefits for its members. The actuarial methods and assumptions used are those adopted by the CalPERS Board of Administration. The required employer contribution for this year into the plan for the fiscal year ended June 30, 2011 was 9.846%, of their annual covered payroll. The contribution requirements of the plan members are established by State statute and the employer contribution rate is established and may be amended by PERS. The District's employer contribution for the last three fiscal years, which were equal to the required contribution each year were $270,670, $263,845, and $222,028 for the years ended June 30, 2011, 2010, and 2009 respectively. PERS does not provide individual plan trend information for risk pools.

7. OTHER POST EMPLOYMENT BENEFITS:

Plan Description:

The District's defined benefit postemployment healthcare plan (DPHP), provides medical benefits to eligible retired District employees and beneficiaries. DPHP is part of the Public Agency portion of the California Employers' Retiree Benefit Trust Fund (CERBT), an agent multiple-employer plan administered by California Public Employees' Retirement System (CalPERS), which acts as a common investment and administrative agent for participating public employers within the State of California. A menu of benefit provisions as well as other requirements is established by State statute within the Public Employees' Retirement Law. DPHP selects optional benefit provisions from the benefit menu by contract with CalPERS and adopts those benefits through District resolution. CalPERS issues a separate Comprehensive Annual Financial Report. Copies of the CalPERS' annual financial report may be obtained from the CalPERS Executive Office, 400 P Street, Sacramento, California 95814.

Funding Policy:

The contribution requirements of plan members and the District are established and may be amended by the Board of Directors. DPHP members receiving benefits contribute based on their selected plan options. The District makes all contributions of the plan members.

7. OTHER POST EMPLOYMENT BENEFITS (Continued):

Annual OPEB Cost and Net OPEB Obligation/Asset:

The District's annual OPEB cost (expense) is calculated based on the annual required contribution of the employer (ARC), an amount actuarially determined in accordance with the parameters of GASB Statement 45. The ARC represents a level of funding that, if paid on an ongoing basis is projected to cover the normal annual cost. Any unfunded actuarial liability (or funding excess) is amortized over a period not to exceed thirty years. The current ARC rate is 3.4% of the annual covered payroll.

The following table shows the components of the District's annual OPEB cost for the year ending June 30, 2011, the amount actually contributed to the plan, and changes in the District's net OPEB obligation/asset:

Annual Required Contribution (ARC)	$ 111,000
Interest on net OPEB asset	7,100
Adjustment to Annual Required Contribution (ARC)	(7,100)
Annual OPEB cost (expense)	111,000
Contributions made	(5,700)
Increase in net OPEB asset	105,300
Net OPEB obligation - beginning of year	156,500
Net OPEB obligation - end of year	$ 261,800

The District's annual OPEB cost, the percentage of annual OPEB cost contributed to the plan, and the net OPEB obligation for the fiscal years 2011, 2010 and 2009 were as follows:

THREE-YEAR TREND INFORMATION FOR CERBT

Fiscal Year	Annual OPEB Cost (AOC)	Percentage of OPEB Cost Contributed	Net OPEB Obligation
6/30/2011	$ 111,000	5.1%	$ 261,800
6/30/2010	87,400	6.8%	156,500
6/30/2009	79,000	5.1%	75,000

Funded Status and Funding Progress:

The funded status of the plan as of June 30, 2010, the most recent actuarial valuation date, was as follows:

Actuarial Accrued Liability (AAL)	$ 631,000
Actuarial Value of Plan Assets	-
Unfunded Actuarial Accrued Liability (UAAL)	631,000
Funded Ratio (Actuarial Value of Plan Assets/AAL)	0.0%
Covered Payroll (Active Members)	3,079,000
UAAL as a Percentage of Covered Payroll	20.5%

7. OTHER POST EMPLOYMENT BENEFITS (Continued)

Actuarial Methods and Assumptions:

Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and the healthcare cost trend. Amounts determined regarding the funded status of the plan and the annual required contributions of the employer are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. 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 liabilities for the benefits.

Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and the plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between employer and plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities and the actuarial assets, consistent with the long-term perspective of the calculations.

The following is a summary of the actuarial assumptions and methods:

Valuation Date	June 30, 2010
Actuarial Cost Method	Entry Age Normal Cost Method
Amortization Method	Level Percent of Payroll
Remaining Amortization Period	28 Years as of the Valuation Date
Asset Valuation method	15 Year Smoothed Market
Actuarial Assumptions:	
Investment Rate of Return	4.25% (Net of Administrative Expenses)
Projected Salary Increase	3.25%
Inflation	3.00%
PEMHCA Minimum Growth	4.50%
Individual Salary Growth	CalPERS 1997-2007 Experience Study

8. SELF-INSURANCE RISK POOL:

Public Entity Risk Management Authority:

The Water District is a member of the Public Entity Risk Management Authority (PERMA), a joint powers authority of 28 California cities and districts, for the purpose of pooling the District's risk for worker's compensation insurance with those of other member cities and districts. The Governing Board of PERMA is comprised of directors nominated and selected by each member city and district. Each governing board member has one vote regarding all financial and management issues coming before the Board.

Each member is billed annually and premiums are paid quarterly. Estimated premiums for claims to be paid and a reserve are advanced upon joining PERMA. Each year PERMA adjusts its premiums based on District payroll figures, claims paid, and claims incurred but not reported. The District receives audited financial statements of PERMA each year which have been audited by other auditors.

8. SELF-INSURANCE RISK POOL (Continued):

Public Entity Risk Management Authority (Continued):

The District is self-insured for the first $250,000 of each claim and PERMA will assume each claim's liability between $250,000 and $10,000,000. There were no instances in the past three years where a settlement exceeded the District's coverage.

9. DERIVATIVE INSTRUMENT - INTEREST RATE SWAP AGREEMENT:

Objective:

The Hesperia Water District executed an interest rate swap agreement on June 1, 2005 with swap provider Bank of America, N.A (counterparty) in connection with the issuance of the $18,040,000 Variable Rate Lease Revenue Refunding Bonds, Taxable Series 1998A (Federally Taxable). The Swap Agreement is a 15 year swap agreement scheduled to terminate on June 1, 2020. The swap establishes a fixed interest rate of 5.96%.

Details on the swap agreement are as follows:

Notional Amount	Interest Rate	Issue	Termination Date	Intial Effective Date
$ 10,000,000	5.96%	Bank of America	6/1/2020	6/1/2005

Terms:

Under the swap agreement, the Water District will make a monthly interest payment at the fixed rate of 5.96%. The Water District will receive a variable rate interest payment for those variable interest rates in excess of the 5.96% cap and makes a payment if the variable rate is less than 5.96%. The rate is adjusted weekly every Wednesday at the 1-Month USD-LIBOR-BBA rate. The swap is for a total notional amount of $10,000,000 and will terminate on June 1, 2020.

Summary of Activities in Cash Flow Hedging Derivative Instrument:

Notional Amount	Fair Value At June 30, 2010	Change In Fair Value	Fair Value At June 30, 2011
$ 10,000,000	$ (2,641,195)	$ 284,001	$ (2,357,194)

As of June 30, 2011, the negative fair value of $2,357,194 is reported as a deferred asset from derivative instruments and a liability from derivative instruments in the Statements of Net Assets. GASB 53, Accounting and Financial Reporting for Derivative Instruments, was implemented for the year ending June 30, 2010.

Credit Risk:

As of June 30, 2011, the Water District was exposed to credit risk because the swap had a negative fair value. However, should interest rates change and the fair value of the swap becomes positive, the Water District would not be exposed to credit risk in the amount of the derivative's fair value.

The swaps counterparty, Bank of America N.A., have the following credit ratings:

	Standards & Poor	Moody's
Bank of America N.A.	A	A2

9. DERIVATIVE INSTRUMENT - INTEREST RATE SWAP AGREEMENT (Continued):

Basis Risk:

The swaps do expose the Water District to basis risk, which refers to a mismatch between the interest rate received from the swap contract and the interest paid on the variable rate payments to be made on the debt. The Water District pays the counterparty a fixed interest rate of 5.96% and receives a variable rate in excess of the 5.96% cap, based on the 1-month UDS-LIBOR-BBA. The Water District is at risk that the variable interest rate calculated on the debt is less than the 5.96%.

Termination Risk:

The swaps may be terminated by the Water District or the counterparty if the other party fails to perform under the terms of the swap agreements. In addition, the Water District has the option to terminate the swaps upon proper notification to the counterparty. If the swaps are terminated, the Water District would prospectively pay the variable rates on the portion of the outstanding bonds related to the swap agreements. The termination of the swap agreements could therefore increase the Water District's total debt service. Also, if at the time of the termination, the swaps have a negative fair value, the Water District would be liable to the counterparty for a payment equal to such negative fair value. As of June 30, 2011 the swap had a negative fair value of $2,357,194.

Swap Payments and Associated Debt:

Using a fixed rate of 5.96% related to a swap agreement for $10,000,000 of the $18,040,000 Variable Rate Lease Revenue Refunding Bonds, Taxable Series 1998A, as of June 30, 2011, debt service requirements of the Bonds and the swap payments through the swap termination date of June 1, 2020, assuming a current variable interest rate of 0.19% are as follows. As rates vary, the variable rate interest payments and net swap payments will vary.

Year Ending	Variable Rate Debt			Interest Rate	Fixed Debt
June 30,	Principal	Interest	Total	Swap, Net	Service
2012	$ -	$ 19,000	$ 19,000	$ 577,000	$ 577,000
2013	-	19,000	19,000	577,000	577,000
2014	-	19,000	19,000	577,000	577,000
2015	-	19,000	19,000	577,000	577,000
2016	-	19,000	19,000	577,000	577,000
2017-2020	-	61,864	61,864	1,878,712	1,878,712

REQUIRED SUPPLEMENTARY INFORMATION

Schedule of Funding Progress for DPHP

Actuarial Valuation Date	Actuarial Value of Assets (A)	Actuarial Accrued Liability (AAL) Entry Age (B)	Unfunded (Over Funded) AAL (UAAL) (B - A)	Funded Ratio (A / B)	Covered Payroll (C)	UAAL as a % of Covered Payroll (B - A / C)
6/30/2010:						
Water	$ -	$ 631,000	$ 631,000	0.0%	$ 3,079,000	20.5%
Total	$ -	$ 631,000	$ 631,000	0.0%	$ 3,079,000	20.5%
6/30/2009:						
Water	n/a	n/a	n/a	n/a	n/a	n/a
Total	n/a	n/a	n/a	n/a	n/a	n/a
6/30/2008:						
Water	$ -	$ 383,000	$ 383,000	0.0%	$ 2,861,500	13.4%
Total	$ -	$ 383,000	$ 383,000	0.0%	$ 2,861,500	13.4%

n/a The Water District is only required to perform actuarial valuations biennially. An actuarial valuation was not performed for the year ending June 30, 2009.

See accompanying independent auditors' report.