

# **FUNDING AND RESERVES POLICY**

## **PART 1: INTRODUCTION**

### **1. OVERVIEW**

- 1.1 The funding of operating and capital budgets is done on an annual basis for a three year horizon. The budget must be balanced from both accounting perspective as well as a cash perspective.
- 1.2 The Council set as a long term objective a financially sustainable municipality with acceptable levels of service delivery to the community. Therefore, this policy aims to set standards and guidelines towards ensuring financial viability and sustainability over both the short-term and long-term and includes funding as well as reserves requirements.

### **2. OBJECTIVE OF THE POLICY**

- 2.1 The objective of the policy is to set out the assumptions and methodology for estimating the following:
- a) Projected billings, collections and all direct revenues;
  - b) The provision for revenue that will not be collected;
  - c) The funds the municipality can expect to receive from investments;
  - d) The municipality's borrowing requirements;
  - e) The funds to be set aside in reserves;
  - f) The proceeds the municipality can expect to receive from the transfer or disposal of assets;
- 2.2 Furthermore; the policy is aimed at ensuring that the operating and capital budgets of council are appropriately funded and to ensure that provisions and reserves are maintained at the required levels to avoid future year unfunded liabilities.

### **3. GUIDING PRINCIPLES**

3.1 Tswelopele Local Municipality's Funding and Reserves Policy is based on the following principles:

- a) Affordability,
- b) Financial sustainability
- c) Equity, and
- d) Efficacy

## **PART 2: FUNDING POLICY**

### **1. LEGISLATIVE REQUIREMENTS**

1.1 In terms of Sections 18 and 19 of the Municipal Finance Management Act (Act No 56 of 2003) (MFMA), an annual budget may only be funded from:

1.1.1 Realistically anticipated revenues to be collected;

1.1.2 Cash backed accumulated funds from previous years' surpluses not committed for other purposes.

1.1.3 Borrowed funds, but only for capital projects.

1.2 Furthermore, spending on a capital project may only be commenced once the funding sources have been considered, are available and have not been committed for other purposes.

1.3 The requirements of the MFMA are therefore clear in that the budget must be cash funded i.e. cash receipts inclusive of prior cash surpluses must equal or be more than cash paid.

- 1.4 In determining whether the budget is actually cash funded and ensuring long term financial sustainability, the municipality will use analytical processes, including those specified by National Treasury from time to time.

## **2. BASIS FOR APPROVAL**

- 2.1 The Council will not approve an annual budget which is not cash funded or where any of the indicators as listed in this document and other documents as issued by Provincial / National Treasury are negative, unless acceptable reasons can be provided for non-compliance, and provided that the requirements of the Municipal Finance Management Act (including circulars and guidelines) have been considered.

## **3. CASH MANAGEMENT**

- 3.1 Cash must be managed in terms of the municipality's Cash/Banking and Investment Policy, together with any requirements in this policy.

## **4. DEBT MANAGEMENT**

- 4.1 Debt must be managed in terms of the municipality's Credit Control and Debt Collection / Management Policy, together with any requirements in this policy.

## **5. FUNDING THE OPERATING BUDGET**

- 5.1 The municipality's objective is that the user of municipal services must pay for such services in the period it occurs. The municipality however, recognises the plight of the poor, and in line with national and provincial objectives, the municipality commits itself to subsidised services to the poor. This will necessitate cross subsidisation in tariffs to be calculated in the budget process.

## **6. PRINCIPLE WHEN COMPILING THE OPERATING BUDGET**

- 6.1 The following specific principles apply when compiling the operating budget:

- 6.1.1 The budget must be cash funded, i.e. revenue and expenditure projections must be realistic and the provision for impairment of receivables must be calculated on proven recovery rates;
- 6.1.2 Growth parameters must be realistic and be based on historic patterns adjusted for current reliable information;
- 3.1.1 Tariff adjustments must be fair, taking into consideration general inflation indicators as well as the geographic region's ability to pay;
- 3.1.2 Where possible, the tariff must reflect the cost of providing such services;
- 6.1.5 Revenue from Government Grants and Subsidies must be in accordance with the amounts promulgated in the Division of Revenue Act, confirmed provincial transfers and any possible transfers to or from other municipalities.
- 6.1.5 For the purpose of the Cash flow budget any National or Provincial grants that have been re-appropriated for roll-over purposes must be excluded from the calculation as it must be included in changes in Cash and Cash Equivalents and Payables.
- 6.1.6 Furthermore, in the budget the total grants recognised as revenue must equal the total expected expenditure from grants, inclusive of capital expenditure and VAT as per directive given in MFMA Circular 48.
- 6.1.7 Projected revenue from services charges must be reflected as net (all billing less revenue foregone, which is free basic services, discounts and rebates).
- 6.1.8 Projected revenue from property rates must include all rates to be levied, but rebates and discounts must be budgeted for as either revenue foregone or a grant, as per directive in MFMA Budget Circular 51, depending on the conditions of the exemption, rebate or reduction.
- 6.1.8 For the purpose of the Cash flow Budget all rebates and discounts must be deducted from the projected revenue.

- 6.1.9 Only changes in fair values related to cash may be included in the cash flow budget. Changes to unamortised discount must be included in the Operating Budget but excluded in the cash flow budget.
- 6.1.10 Employee related costs include contributions to non-current and current employee benefits. It is acknowledged that the non-current benefits' requirements are well above the initial cash capabilities of the municipality, and it is therefore determined that provision for the short term portion of employee benefits, as well as an operating surplus be included in the operating budget, in order to build sufficient cash for these requirements. The cash portion of the employee benefits must be accounted for in an "Employee Benefits Reserve".
- 6.1.11 Depreciation must be fully budgeted for in the operating budget.
- 6.1.12 In order to ensure a sufficient accumulation of cash for the replacement of Property, Plant and Equipment and Intangible Assets, the amount of depreciation on assets funded from own sources, excluding assets funded from grants, public contributions and external loans must be reflected as a surplus on the cash flow budget.
- 6.1.13 Contributions to provisions (non-current and current) do not form part of the cash flow. It is however, necessary to provide for an increase in cash resources in order to comply with the conditions of the provision at the time when it is needed.
- 6.1.14 It is therefore a requirement that the contribution to current provisions, is budgeted as cash surpluses until the necessary funding level is obtained.

## **7. FUNDING THE CAPITAL BUDGET**

- 7.1 The municipality's objective is to maintain, through proper maintenance and replacement measures, existing levels of service and to improve and implement services which are neglected or non-existent.
- 7.2 In order to achieve this objective the municipality must annually, within financial means, budget for the replacement of redundant assets as well as new assets.

- 7.3 The capital budget can be funded by way of own contributions, grants, public contributions as well as external loans.
- 7.4 The capital budget financed from own contributions must primarily be funded from the Capital Replacement Reserve.
- 7.5 Notwithstanding the above the capital budget or portions thereof may also be funded from surplus cash. The allocations of the funding sources from own contributions are determined during the budget process.
- 7.6 Grants for capital expenditure have become a common practice, especially in order to extend service delivery to previously disadvantaged areas. While such grants are welcomed, care should also be taken that unusual grant funding does not place an unreasonable burden on the residents for future maintenance costs which may be higher than their ability to pay.
- 7.7 It is therefore determined that the accounting officer must evaluate the long term effect of unusual capital grants on future tariffs, and if deemed necessary, report on such to Council.
- 7.8 It is furthermore determined that the depreciation charges on assets financed from grants and donations must not have a negative effect on tariffs charged to the users of such assets. The Accounting Officer must put such accounting measures in place to comply with this requirement, to a reasonable extent.
- 7.9 The municipality may only raise loans in accordance with Municipal Finance Management Act and Debt Management Policy.
- 7.10 The Accounting Officer must also put such accounting measures in place to ensure that no unspent portions of loans are utilised for operating purposes. For budgeting purposes any difference between proposed capital spending from loans and proposed loans raised must be included in the cash surplus for the year.

## **8. BASIS OF CALCULATION**

- 8.1 The zero based method is used in preparing the annual capital budget, except in cases where a contractual commitment has been made that would span over more than one financial year.
- 8.2 The annual capital budget shall be based on realistically anticipated revenue (capital loans to be taken up will be deemed to be part of this), which should be equal to the anticipated capital expenditure in order to result in a balanced budget (i.e. all earmarked capital expenses have a funding source).
- 8.3 The impact of the capital budget on the current and future operating budgets in terms of finance charges to be incurred on external loans, depreciation of fixed assets, maintenance of fixed assets and any other operating expenditure to be incurred resulting directly from the capital expenditure, should be carefully analysed when the annual capital budget is being finalized.
- 8.4 In addition, the council shall consider the likely impact of such operational expenses net of any revenues expected to be generated by such item on future property rates and service tariffs.

## **9. FUNDING COMPLIANCE MEASUREMENT**

- 9.1 It is the intention of the municipality to ensure that the annual budget and adjustment budget complies with the requirements of the Municipal Finance Management Act and this policy. For this purpose a set of indicators must be used as part of the budget process and be submitted with the budget.
- 9.2 These indicators include all the indicators as recommended by National Treasury as well as reconciliations according to this policy. Any additional indicators recommended by National Treasury in future must also be taken into account, as well as any additional reconciliation items as either determined by the Council or the Accounting Officer.
  - 9.2.1 Cash and cash equivalents and investments: a positive cash and cash equivalents position throughout the year are crucial. In addition, the forecasted cash position at year-end must at least be the amount as calculated in the reconciliation of cash requirements.



- 9.2.2 Cash plus investments less application of funds: the overall cash position of the municipality must be sufficient to include: unspent conditional grants; unspent conditional public contributions; unspent borrowings; VAT due to SARS; secured investments; the cash portion of statutory funds such as the Housing Development Fund; other working capital requirements; and it must be sufficient to back reserves as approved by the municipality and the portions of provisions as indicated elsewhere in this policy.
- 9.2.3 Monthly average payment covered by cash and cash equivalents (“cash coverage”): this indicator shows the level of risk should the municipality experience financial stress.
- 9.2.4 Surplus/deficit excluding depreciation offsets: in certain circumstances, the operating budget, which includes depreciation charges on assets funded by grants and public contributions, as well as on revalued assets, will result in a deficit. In order to ensure a “balanced” budget but excluding such depreciation charges, the depreciation charges may be offset against the net surplus / deficit. Should the budget result in a deficit after the offsetting, the budget will be deemed unfunded and must be revised.
- 9.2.5 Property rates/service charge revenue percentage increase less macro inflation target: the intention of this indicator is to ensure that tariff increases are in line with macro-economic targets, but also to ensure that revenue increases for the expected growth in the geographic area is realistically calculated.
- 9.2.6 Cash collection rate: the object of the indicator is to establish whether the projected cash to be collected is realistic and complies with section 18 of the MFMA. The collection rate for calculating the provision for impairment of receivables must be based on past and current performance. Past experience refers to the collection rates of the prior years and current performance refers to the collection rate of the current financial year as from 1 July.
- 9.2.7 Debt impairment expense as a percentage of billable revenue: this indicator provides information whether the contribution to the provision for impairment of receivables is adequate. In theory it should be equal to the difference between 100% and the cash

collection rate, but other factors such as past performance might have an influence on it. Any difference, however, must be motivated in the budget report.

- 9.2.8 Capital payments as a percentage of capital expenditure: this indicator provides information as to the timing for payments on capital projects and utilising allowed payment terms.
- 9.2.9 Borrowing as a percentage of capital expenditure (excluding grants and contributions): this indicator provides information as to compliance with the MFMA in determining borrowing needs.
- 9.2.10 Grants revenue as a percentage of grants available: the percentage should never be less than 100% and the recognition of expected unspent grants at the current year-end as revenue in the next financial year must be substantiated in a report.
- 9.2.11 Consumer debtors change (current and non - current): the object of the indicator is to determine whether budgeted reductions in outstanding debtors are realistic. An unacceptable high increase in either current or non-current debtors' balances should be investigated and acted upon.
- 9.2.12 Repairs and maintenance expenditure level: it is of utmost importance that the municipality's Property Plant and Equipment be maintained properly, in order to ensure sustainable service delivery. The budget should allocate sufficient resources to maintain assets and care should be exercised not to allow a declining maintenance program in order to fund other less important expenditure requirements. Similarly, if the maintenance requirements become excessive, it could indicate that a capital renewal strategy should be implemented or reviewed. As a general benchmark the maintenance budget should be between 4% and 8% of the value of assets.
- 9.2.13 Asset renewal/rehabilitation expenditure level: this indicator supports further the indicator for repairs and maintenance. The Accounting Officer must, as part of the capital budget, indicate whether each project is a new asset or a replacement/renewal asset in order to determine whether the renewal program is sufficient or needs revision.

- 9.3 If any of the indicators are negative during the compilation or approval process of the budget, the budget may not be approved until all the indicators provide a positive return, unless any negative indicators can be reasonably explained and future budget projections address the turn-around of these indicators to within acceptable levels.

## **PART 3: RESERVES POLICY**

### **1. INTRODUCTION**

- 1.1 Fund accounting historically formed a huge part of municipal finance in the IMFO standards. Since the municipality changed to General Recognised Accounting Practices (GRAP), fund accounting is no more allowed.
- 1.2 The municipality, however, recognises the importance of providing to the municipality itself, as well as its creditors, financiers, staff, and general public a measure of protection for future losses, as well as providing the necessary cash resources for future capital replacements and other current and non-current liabilities.
- 1.3 Therefore, this policy aims to provide for such measure of protection by creating certain reserves.

### **2. LEGAL REQUIREMENTS**

- 2.1 There are no specific legal requirements for the creation of reserves, except for the Housing Development Fund. The GRAP Standards itself also do not provide for reserves.
- 2.2 However, the GRAP “Framework for the Preparation and Presentation of Financial Statements” states in paragraph 91 that such reserves may be created, but “Fund Accounting” is not allowed and any such reserves must be a “legal” reserve, i.e. created by law or Council Resolution.

### **3 TYPES OF RESERVES**

- 3.1 Reserves can be classified into two main categories being “cash funded reserves” and “non-cash funded reserves”.
- 3.2 Cash Funded Reserves: In order to provide for sufficient cash resources for future expenditure, the municipality hereby approves the establishment of the following reserves:
  - 3.2.1 Capital Replacement Reserve (CRR): the CRR is to be utilised for future capital expenditure from own funds and may not be used for maintenance– or other operating expenditure. The CRR must be cash-backed and the Accounting Officer is hereby delegated to determine the contribution to the CRR during the compilation of the annual financial statements.
  - 3.2.2 Employee benefits reserve: the aim of the reserve is to ensure sufficient cash resources are available for the future payment of employee benefits. The contributions to the reserve must be made in accordance with the directives set in this Funding Policy.
  - 3.2.3 Non-current provisions reserve: the aim of this reserve is to ensure sufficient cash resources are available for the future payment of non – current provisions. The contributions to the reserve must be made in accordance with the directives set in this Funding Policy.
  - 3.2.4 Valuation reserve: the aim of this reserve is to ensure sufficient cash resources are available to undertake a General Valuation as per the Municipal Property Rates Act. The contribution to this reserve should be approximately 25% of the anticipated cost of the General Valuation and the Accounting Officer is hereby delegated to determine this amount annually during the compilation of the annual financial statements.
  - 3.2.5 Other statutory reserves: it may be necessary to create reserves prescribed by law, such as the Housing Development Fund. The Accounting Officer must create such reserves according to the directives in the relevant laws.
- 3.3 **NON – CASH FUNDED RESERVES:** it might be necessary to create non – cash funded reserves for a variety of reasons, including GRAP requirements. The Accounting Officer must create any reserves prescribed by the accounting standards, such as the Revaluation Reserve, if required. The Accounting Officer is hereby delegated and may also in the discretion of the Accounting Officer, create reserves for future depreciation offsetting, in the absence of a standard similar to IAS 20.

#### **4. ACCOUNTING FOR RESERVES**

- 4.1 Revaluation reserve: the accounting for the Revaluation Reserve must be done in accordance with the requirements of GRAP 17.
- 4.2 Other reserves: the accounting for all other reserves must be processed through the Statement of Financial Performance. The required transfer to or from the reserves must be processed in the Statement of Net Assets to or from the accumulated surplus. It is a condition of GRAP and this policy that no transactions may be directly appropriated against these reserves.

#### **5. REVIEW OF THE POLICY**

- 5.1 This Funding and Reserves Policy is the only policy of the municipality and replaces any past policies in this regard. Any revision of the policy must be approved by the Municipal Council.
- 5.2 Whenever the Minister of Finance or the National Treasury or the Auditor – General requests changes to the policy by way of legislation, changes to GRAP or otherwise, it must be reviewed and submitted for consideration by the Council on an annual basis. Such submission must be accompanied with a full description of the reasons for the change to the policy.