

mSCOA Project: Position Paper on Accumulated Surplus, Reserves and Funds

Position papers do not have any legal status in its own right. Subject matters dealt with in position papers are identified for specific consideration and may be matters controversial in nature, accounting treatment become relevant in order to achieve consistencies in classification throughout the local government sector.

Position papers need to be read together with the Project Summary Document as updated periodically by National Treasury.

Position papers DO NOT replace any National Treasury guidelines, circulars, practice notes or implementation guidelines.

Position papers are prepared by the mSCOA Project Team based on information collected through the mSCOA Project Lifecycle. Consultation with interested parties may be necessary in concluding on subject matters.

Terminology applied in the position paper will be specifically defined for updating the Standard Terminology list as published on the National Treasury web as part of the mSCOA project documents.

Frequently asked questions received are used as part of the basis for research to cross reference to the specific queries for retaining the completeness of this source of information.

Conclusion to be formulated on the position taken by National Treasury after conducting consultation as may be defined by the mSCOA Technical Work Group, and supplemented by the views of the mSCOA Project Steering Committee.

Recommendations to the mSCOA Project Steering Committee may include appropriate reference to any National Treasury documentation requiring review following the outcome of the conclusion on the position paper.

Contents

BACKGROUND.....	3
May 2004 - Guideline for the Implementation of Accounting Standards of Generally Recognised Accounting Practice	4
Municipal Finance Management Act No 56 of 2003 (MFMA) Circular No 18 on Accounting Standards Implementation dated 23 June 2005	4
The GRAP Implementation Guide for Municipalities issued by National Treasury in September 2008.....	5
THE IMPACT OF THE STANDARDS IMPELEMTATION PROCESS ON UNBUNDLING FUND AND RESERVES ACCOUNTS UTILISED UNDER THE FUND ACCOUNTING MODEL	6
THE PROBLEM STATEMENT	6
LEGISLATIVE AND ACCOUNTING STANDARDS	7
Legislation	7
GRAP references	7
POSITION OF mSCOA	8
NATIONAL TREASURY DOCUMENTS TO BE REVISED FOLLOWING THE ADOPTION OF THIS POSITION PAPER.....	12
CONCLUSION	12
RECOMMENDATION	13
ANNEXURE A: COMMENTS AND QUERIES RECEIVED INFORMING THE PROBLEM STATEMENT	14
ANNEXURE B - MAY 2004 – GUIDELINES FOR THE IMPLEMENTATION OF ACCOUNTING STANDARDS OF GENERALLY RECOGNISED ACCOUNTING PRACTICE ...	15
Summary of Fund Accounts prior to the “New Standards” with the Implementation Requirements.....	15
Unbundling Loans Redeemed and Other Capital Receipts.....	27
ANNEXURE C – GUIDELINES FOR THE IMPLEMENTATION OF ACCOUNTING STANDARDS OF GENERALLY RECOGNISED ACCOUNTING PRACTICE ISSUED WITH MFMA CIRCULAR 18 (JUNE 2005)	31
Process to establish the Capital Replacement Reserve, the Capitalisation Reserve and the External Financing Fund.....	31

BACKGROUND

1. Section 216(1)(a) of the Constitution requires the National Treasury to introduce Generally Recognised Accounting Practice (GRAP). To give effect to this provision, the Minister of Finance established the Accounting Standards Boards (ASB) in terms of section 87(1) of the Public Finance Management Act, No 1 of 1999. Section 122(3) of the Municipal Finance Management Act (MFMA) requires municipalities and municipal entities to prepare financial statements in accordance with the Standards of GRAP, phased in.
2. The Municipal Finance Management Act No 56 of 2003 (MFMA) has set the reform agenda in the financial management of local government. The broader reforms have been underpinned by the need for appropriate planning, quality budgeting, the execution and monitoring of plans and budgets, understandable reporting and information that will assist decision makers and the public to measure performance and service delivery.
3. National Treasury in association with other key stakeholders have led the development of accounting reforms since 1998. These reforms have consistently been updated as the accounting standards evolved.
4. The then GAMAP standards were primarily based on SA GAAP as at 30 November 1997, which at that point in time was considered fair representation.
5. In August 2002, the ASB began the process of reviewing and approving Statement of Generally Accepted Municipal Accounting Practice (GAMAP) and developing new Standards of GRAP. GAMAP was considered as interim standards for municipalities and municipal entities until the national standards of GRAP had been developed and approved by the ASB.
6. The National Treasury conducted a survey of municipal finance management capacity during February and March 2004, after researching material from StatsSA, the Demarcation Board and the Department of Provincial and Local Government. The survey was circulated to the then 284 municipalities. This information was utilised to categorise municipalities into three category levels namely:
 - High Capacity – relatively high scores
 - Medium Capacity – medium scores
 - Low Capacity – low scores.
7. According to the above capacity categories the implementation date of the standards was respectively set as 1 July 2004, 1 July 2005 and 1 July 2006.

8. The conversion from the fund accounting framework or the IMFO model applied by municipalities, to the “capital accounting model” required a number of implementation processes, i. e. financing of items of property, plant and equipment, provisions and internal funds and reserves, etc.
9. The implementation was guided by the “National Treasury Guidelines on Implementation of Approved Standards of Generally Recognised Accounting Practice – June 2005”.
10. The evolutionary process initially adopted by National Treasury, explained in MFMA Circular 18 on Accounting Standards Implementation, read with further guidance, dealt with in the paragraphs to follow, sets the scene for the problem statement defined in this Position Paper.

Guideline for the Implementation of Accounting Standards of Generally Recognised Accounting Practice dated May 2004

11. This Guideline introduced the principles of the “new standards” to Local Government, preceding the issue of Municipal Finance Management Act No 56 of 2003 (MFMA) Circular No 18 on Accounting Standards Implementation dated 23 June 2005. Discussed in more detail hereunder.
12. ANNEXURE B - MAY 2004 – GUIDELINES FOR THE IMPLEMENTATION OF ACCOUNTING STANDARDS OF GENERALLY RECOGNISED ACCOUNTING PRACTICE provides a summary specific to funds and reserves emanating from the implementation of the “new standards”.

Municipal Finance Management Act No 56 of 2003 (MFMA) Circular No 18 on Accounting Standards Implementation dated 23 June 2005

13. This Circular contained the National Treasury Guidelines for the implementation of the Standards of GRAP derived from the GAMAP Standards.
14. These standards amongst other requirements provide guidance to municipalities on “converting the Statement of Financial Position at the beginning of the financial year from fund accounting to the new standards formats”.
15. Provided in the above guideline the following: “Since fund accounting in terms of GRAP/GAMAP/GAAP, internal funds and reserves should form part of Accumulated Surplus and should not be disclosed on the face of the Statement of Changes in Net Asset. Municipalities can however disclose in a note to the financial statements the internal funds and reserves that are ring-fenced within the accumulated surplus”.
16. Annexure B provide a detailed discussion of the unbundling of internal reserves and funds as discussed in the initial guidelines released by National

Treasury in May 2004. Chapter 5 of the June 2005 Guideline replaces the concept introduced in the earlier version of the “Asset Finance Reserve” with the “Capitalisation Reserve”. Refer to ANNEXURE C – GUIDELINES FOR THE IMPLEMENTATION OF ACCOUNTING STANDARDS OF GENERALLY RECOGNISED ACCOUNTING PRACTICE ISSUED WITH MFMA CIRCULAR 18.

17. At this stage the following “Fund and Reserve Accounts” had been introduced as summarised within Annexures B and C:

- Housing and Townships Development Funding
- Asset Finance Reserve (renamed to Capital Replacement Reserve)
- Future Depreciation Reserves
- Self-insurance Reserve
- Liabilities Trust Fund
- Loan Redemptions Fund (renamed to Consolidated Loans Fund)
- Capitalisation Reserve
- External Financing Fund

The GRAP¹ Implementation Guide for Municipalities issued by National Treasury in September 2008

18. This guideline clarified to municipalities that, since fund accounting is not allowed in terms of GRAP/GAMAP/GAAP, internal funds and reserves should form part of accumulated surplus and should not be disclosed on the face of the statement of changes in net asset. Municipalities can however disclose in a note to the financial statements the internal funds and reserves that are ring-fenced within the accumulated surplus.

19. In the municipal environment, the following internal funds and reserves were established in the past:

- Capital Replacement Reserve (CRR)
- Self-Insurance Reserve (SIR)
- Capitalisation Reserve (CR)
- Reserve established for Compensation for Occupational Injuries and Diseases (COID Reserve)
- Government Grant Reserve (GGR) and
- Donations and Public Contributions Reserve
- Housing Development Fund (HDF)

¹ mfma.treasury.gov.za/guidelines/pages/grao.aspx

THE IMPACT OF THE STANDARDS IMPELEMENTATION PROCESS ON UNBUNDLING FUNDS

AND RESERVES ACCOUNTS UTILISED UNDER THE FUND ACCOUNTING MODEL

THE PROBLEM STATEMENT

20. The GRAP Framework does not specifically discuss the creation and management of internal funds and reserves. GRAP either requires the creation of reserves or acknowledges that entities are required to create them (compelled by statute).
21. Municipalities are not treating the Reserves and Funds consistently, some municipalities are not apportioning the Accumulated Surplus between cash backed funds and other assets (such as Property, plant and equipment).
22. Furthermore, municipalities are not using the reserves as envisioned when created, and in some cases are unsure of the purposes of the reserves and what they are meant to fund.
23. It is further noted that municipalities are also unsure when distinguishing between discretionary and required (either through the accounting framework or legislation) reserves.
24. Where reserves have been created, for statutory or other purposes, the treatment thereof in the general ledger and the annual financial statements has been inconsistent.
25. Furthermore, some of the reserves may not be “Cash-Backed” or funded as to have money available when needed, for example assets need to be replaced provided for within the municipal policy requirements for the Capital Replacement Reserve/
26. Municipalities had been advised to review their existing chart of accounts and determine if the accounts are still relevant, supported by sufficient policies and still in use. Guidance to be taken from the following Annexures to review “legacy fund accounting relating to Reserves and Funds” and proposed unbundling requirements prior to converting to mSCOA:
 - ANNEXURE B - MAY 2004 – GUIDELINES FOR THE IMPLEMENTATION OF ACCOUNTING STANDARDS OF GENERALLY RECOGNISED ACCOUNTING PRACTICE
 - ANNEXURE C – GUIDELINES FOR THE IMPLEMENTATION OF ACCOUNTING STANDARDS OF GENERALLY RECOGNISED ACCOUNTING PRACTICE ISSUED WITH MFMA CIRCULAR 18 (JUNE 2005)

27. The mSCOA Classification Framework require standardisation of existing practices. Therefore, the need for this Position Paper to guide municipalities in their request for the opening of “fund and reserve accounts” specific to the municipalities requirement.
28. The National Treasury Guidance on the subject matter is spread over various documents and does not provide a continuous flow from the earlier fund accounting modules through the evolution thereof to the Standards of GRAP. Confusion exist on how to deal with some of the legacy fund accounts not necessarily relevant in the context of the municipalities funding mechanism.

LEGISLATIVE AND ACCOUNTING STANDARDS

Legislation

29. Section 18 of the MFMA states that an annual budget may only be funded from-
 - a. Realistically anticipated revenues to be collected;
 - b. Cash-backed accumulated funds from previous years’ surpluses not committed for other purposes; and
 - c. Borrowed funds, but only for the capital budget.
30. MFMA Circular 28 and 42 issued by National Treasury provide specifications that the budget of a municipality must be “funded”.
31. MFMA Circular 42 states that the capital budget may be funded by cash-backed accumulated funds from the previous year, i.e. those current cash surpluses, less future commitments.
32. Section 122(3) of the MFMA requires that annual financial statements and consolidated annual financial statements must be prepared in accordance with generally recognised accounting practice prescribed in terms of section 91 (1) (b) of the Public Finance Management Act.

GRAP references

33. Paragraph 110 of GRAP 1 (Presentation of Financial Statements) states the following with regard to presentation in the Statement of Changes in Net Assets:

“An entity shall present a statement of changes in net assets as required by paragraph .11. The statement of changes in net assets includes the following information:

 - (a) the surplus or deficit for the period;

- (b) each item of revenue and expenses for the period that, as required by other Standards of GRAP, is recognised directly in net assets, and the total of these items;
- (c) total revenue and expenses for the period (calculated as the sum of (a) and (b)), showing separately the total amounts attributable to owners of the controlling entity and to minority interest; and
- (d) for each component of net assets, the effects of changes in accounting policies and the corrections of errors recognised in accordance with the Standard of GRAP on Accounting Policies, Changes in Accounting Estimates and Errors.

34. Paragraph 111 of GRAP 1 states that

“An entity shall also present, either on the face of the statement of changes in net assets or in the notes:

- (a) the amounts of transactions with owners acting in their capacity as owners, showing separately distributions to owners;
- (b) the balance of accumulated surpluses or deficits at the beginning of the period and at the reporting date, and the changes during the period; and
- (c) to the extent that components of net assets are separately disclosed, a reconciliation between the carrying amount of each component of net assets and each reserve at the beginning and the end of the period, separately disclosing each change.
- The Conceptual Framework issued by the Accounting Standards Board in June 2004 contains the following: “The creation of reserves is sometimes required by statute or other law in order to give the entity and its creditors an added measure of protection from the effects of future losses. The existence and size of these legal, statutory and tax reserves is information that can be relevant to the decision-making needs of users. Transfers to such reserves are deemed to be appropriations of accumulated surpluses and deficits, and not expenses. Any such transfers are disclosed in the statement of changes in net assets.”

POSITION OF mSCOA

35. The table hereunder summarise the few Reserves and Funds retained in mSCOA version 5.5 with reason for allowing these accounts. These account are set-up at request of the municipality by National Treasury without any further breakdown required.

36. Due to the complexities inherent to fund and reserve accounts with the “cash backing” provided for in the Fund Segment and the movement analysed through the Statement of Changes in Net Asset, National Treasury would not recommend that municipalities make use of the “general provision” to add further detail at the discretion of municipalities. Th

37.

Description	Explanation of Reserve or Fund
Capital Replacement Reserve [mSCOA Reference: bb73c819-0d38-44f5-a61f-f86e343781bc]	
Need to be supported by a Financial Standard Operating Procedure ²	<p>The purpose of the Capital Replacement Reserve is to set aside funds for financing property, plant and equipment. This reserve is therefore a “asset financing source” that represents an alternative to other funding source available to the municipality namely external loans (interest bearing borrowings) and transfers and subsidies.</p> <p>The balance on the Capital Replacement Reserve is always represented by cash.</p>
Government Grants Reserve and Public Contributions Reserve [mSCOA Reference: Not provided for in mSCOA with Funds and Reserves. Refer to Revenue for Transfers and Subsidies Received and Current Liabilities for Receivables/Unspent Transfers and Receivables]	
<p>Municipalities falling under the modified GRAP, GAMAP & GAAP basis of accounting were allowed an accounting policy choice between the principles in GAMAP 9 and the principles in IAS 20 for the year ended 30 June 2007. Municipalities that chose to account for government grants related to non-current assets in accordance with GAMAP 9 created a Government Grant Reserve and Donations and Public Contributions Reserve on the face of the Statement of Financial Position. Since fund accounting is not allowed in terms of GRAP / GAMAP / GAAP, municipalities are no longer allowed to account for a Government Grant Reserve and Donations and Public Contributions Reserve in the Statement of Changes in Net Assets.</p> <p>Government grants related to a non-current asset with a useful life must be presented in the statement of financial position as deferred income that is recognised as income on a systematic and rational basis over the useful life of the asset.</p> <p>The Standards of GRAP 23 on Non-exchange Revenue provide guidance on the recognition of transfers, covering periods beginning on or after 1 April 2015.</p>	
Housing Development Fund [mSCOA Reference: 8c8a64bd-49e0-449d-9826-282b1a1f5efc]	
The Housing Development fund was established in terms of the Housing Act, (Act No 107 of 1997). Loans from national and provincial government used to finance housing selling schemes	In terms of the Housing Act, all proceeds from housing developments which include rental income and sale of houses must be paid into the Housing Development Fund. Monies standing to credit of the Housing Development Fund can be used only to finance housing developments within the municipal areas subject to the approval of the Provincial MEC responsible for housing. It should be noted that the Housing operating

² Guidance: Topic 6.3 National Treasury GRAP Implementation Guide

Description	Explanation of Reserve or Fund
<p>undertaken by the Municipality were extinguished on 1 April 1998 and transferred to a Housing Development Fund. Housing selling schemes both complete and in progress as at 1 April 1998, were also transferred to the Housing Development Fund</p>	<p>account is included in the Statement of Financial Performance. The net result of the Housing Operating Account is then transferred from/to the accumulated surplus/(deficit). Note that since the HDF was established in terms of legislation it may be reported separately in the statement of financial position and the statement of changes in net assets. The accumulated fund of the HDF includes the following:</p> <ul style="list-style-type: none"> • Accumulated surplus/(deficit) • Loans extinguished on 1 April 1999
<p>Self-insurance Reserve [mSCOA Reference: 769093d0-e06b-44²1-87d6-58411c7b911a]</p>	
<p>Municipalities have Self-Insurance Reserves to set aside amounts to offset potential losses or claims that cannot be insured externally.</p> <p>The balance of the Self-Insurance Reserve is determined based on insurance risk carried by the municipality and past claims history and is increased by a transfer from the accumulated surplus/(deficit).</p>	<p>Claims are settled by transferring a corresponding amount from the self-insurance reserve to the accumulated surplus.</p> <p>This reserve must be cash-backed to effectively manage claims.</p> <p>GRAP 1.111 requires the presentation in the statement of changes in net assets or in the notes of: 1) the balance of accumulated surpluses or deficits at the beginning of the period and at the reporting date, and the changes during the period; and 2) to the extent that components of net assets are separately disclosed, a reconciliation between the carrying amount of each component of net assets and each reserve at the beginning and the end of the period, separately disclosing each change.</p>
<p>Capitalisation Reserve [mSCOA Reference: Outstanding]</p>	
<p>The Capitalisation Reserve represents amounts previously accumulated that were recovered from consumers through rates and tariffs and that have been used to acquire items of Property, Plant and Equipment.</p> <p>These amounts are therefore not available to be used for any other purpose.</p>	<p>This Reserve aims to promote consumer equity by ensuring that consumers are not subject to double taxation when the items of property, plant and equipment acquired through internal loans are depreciated on the introduction of standards.</p> <p>GRAP 1.111 requires the presentation in the statement of changes in net assets or in the notes of: 1) the balance of accumulated surpluses or deficits at the beginning of the period and at the reporting date, and the changes during the period; and 2) to the extent that components of net assets are separately disclosed, a reconciliation between the carrying amount of each component of net assets and each reserve at the beginning and the end of the period, separately disclosing each change.</p>
<p>Compensation for Occupational Injuries and Diseases [mSCOA Reference: 4799999c-c540-4d89-ae5-89b0fa2d4110]</p>	

Description	Explanation of Reserve or Fund
<p>The COID reserve is established for Compensation for Occupational Injuries and Diseases where permission to retain contributions has been obtained from the Compensation Commissioner.</p>	<p>The municipality should ensure that all contributions to, or from the COID reserve are shown as transfers between the COID reserve and Accumulated Surplus.</p> <p>GRAP 1.111 requires the presentation in the statement of changes in net assets or in the notes of: 1) the balance of accumulated surpluses or deficits at the beginning of the period and at the reporting date, and the changes during the period; and 2) to the extent that components of net assets are separately disclosed, as a reconciliation between the carrying amount of each component of net assets and each reserve at the beginning and the end of the period, separately disclosing each change.</p>
<p>Revaluation Reserve [mSCOA Reference: 30f9a578-48dc-4a54-8a35-635f333d2c20]</p>	
<p>A Revaluation Reserve is established upon revaluation of a class of Property, Plant and Equipment, Heritage Assets or Intangible Assets.</p>	<p>Under the revaluation model, the difference between the revalued amount and the carrying amount is recognised in the revaluation surplus. In the case of a reversal of an increase in excess of the increase previously recognised in the revaluation surplus, or a reversal of a decrease previously recognised in surplus or deficit, it will be recognised in surplus or deficit. An amount recognised in surplus or deficit is shown as an impairment loss.</p> <p>The revaluation surplus relating to an asset will be realised over time by transferring some or the whole of the surplus to accumulated surplus or deficit by way of, either:</p> <ul style="list-style-type: none"> • Through the use of the asset: transferring the portion as the asset to which the surplus relates to is depreciated; or • When the asset is derecognised: transferring the portion when the asset to which the surplus relates to is disposed. <p>The transfer of the revaluation surplus may never go through surplus or deficit. Note that the option on how to treat the realisation of the revaluation surplus is an accounting policy choice, which should be applied consistently.</p>

38. Included, in addition to the above Funds and Reserve, based on specific requests made by municipalities supplemented by a Financial Standard Operating Procedure for the management of the specific fund and maintenance of the cash backing for the fund or reserve account are:
- Employee Benefit Reserve – [1f5618e6-cba4-4387-a546-21fd9b61397c]
The aim to 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 a funding and reserve policy.

- Non-current Provisions Reserve – [380676ac-7e39-4ffb-b4ce-ee66339fdde1] *The aim to the 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 a funding and reserve policy.
- Valuation Reserve – [d3b1d697-fc8b-4dd6-8e73-8772e3878b40] - The aim to the reserve is to ensure sufficient cash resources are available to undertake a general valuation as required in terms of the Municipal Property Rates Act, No 6 of 2004. The contributions to the reserve must be made in accordance with the directives set in a funding and reserve policy.

NATIONAL TREASURY DOCUMENTS TO BE REVISED FOLLOWING THE ADOPTION OF THIS POSITION PAPER

39. The following Guidance issued by National Treasury need to be revised and indicated in a mSCOA Circular that they had been replaced by the National Treasury Standards of GRAP 1 Implementation Guide on Presentation of Financial Statements:
- Guideline for the Implementation of Accounting Standards of Generally Recognised Accounting Practice – May 2004
 - MFMA Circular No 18 – Implementation of New Accounting Standards and Format of Annual Financial Statements – 22 June 2005
 - GRAP Implementation Guide for Municipalities – September 2008
40. Budget Reporting Tables and In-year Reporting considerations:
- A8: Cash Backed Reserves/Accumulated Surplus Reconciliation
 - SA3: Supporting Detail to Budget Financial Position

CONCLUSION

41. Municipalities should preferably not make use of Reserves and Funds within its accounting structures, except those defined in paragraph 34.
42. However, if a municipality does elect to allocate surplus funds for future use, the following principles must be adhered to:
- A policy on the reserve must be approved by council, including the reasons for the reserve, the funding arrangements, the utilisation requirements of the reserve and disclosure of the reserves in the financial statements. A copy of the Council approved policy must be attached to the request made

to National Treasury for adding further Fund and Reserve accounts to the mSCOA Classification Framework.

- The reserves must be managed according to the Council approved cash management policy of the municipality. If the reserve is not cash backed, the municipality must document how it will ensure that the reserve is funded.
- Cash-backing is a conditional requirement for making a request to National Treasury for adding Reserve and Fund Accounts to the mSCOA Classification Framework.
- When the Reserve or Fund has been established by legislation (such as the Housing Development Fund) any entries to- and from the reserves must be done either in the municipalities general ledger as a component of Accumulated Surplus (for example the Capitalisation Reserve, the Capital Replacement Reserve, COID and Self Insurance Reserve) or as a Transfer in the Statement of Changes in Net Assets.
- Disclosure of the components of Accumulated Surplus for internal use must be provided as a note to the financial statements, as budgeting decisions, setting of tariffs and other economic decisions are made on the funds. This should replicate the disclosure requirements of GRAP 1 Paragraph 112.

RECOMMENDATION

43. The mSCOA Project Steering Committee to note:

- Version 1 of this Position Paper on Accumulated Surplus, Reserves and Funds was discussed and presented to the ICF at the 9 September 2015 meeting.
- Content discussed and agreement reached by the OAG with the ASB on 15 February 2016.
- Comment period offered to the ASB Forum Members and invitation extended to all municipalities / provincial treasuries from beginning of March to 8 April 2016. Comments received up to 12 July 2016 considered in finalisation of the Position Paper.
- Position Paper to be recommended for publishing to the National Treasury Web.

ANNEXURE A: COMMENTS AND QUERIES RECEIVED INFORMING THE PROBLEM STATEMENT

Reference / Date	From	Number	Query	Response
Letter/Email 9 May 2016	uMhlathuze Hilton Renald	1.	Capitalisation Reserve – what will give rise to this reserve and how it should be funded if you want to have such a fund?	Refer to paragraph 37. This accounts is only included as a “transitional arrangement” from the move from legendary “Fund Accounting Model” to the Standards of GRAP. The available funds should be depleted “at a point in time”, where municipalities have a balance available.
		2,	COID – what is this reserve for, as the municipality pays monthly fees in terms of the COID Legislation.	Refer to paragraph 37. The COID reserve can only be created if a municipality has been exempted from making contributions to the Compensation Commissioner for Occupational Injuries and Diseases.
Letter/Email 8 April 2016	ASB Jeanine Poggiolini	3.	The reserves outlined in the position paper are different to those discussed on page 107 of the project summary on Assets, Liabilities and Net Assets (Section 7.3)	Refer to paragraph 37 read with the PSD. The content of the Position Paper updated to agree with the Funds and Reserves according to mSCOA V5.5 and the Section 7.3 of the Project Summary Document (PSD).

ANNEXURE B - MAY 2004 – GUIDELINES FOR THE IMPLEMENTATION OF ACCOUNTING STANDARDS OF GENERALLY RECOGNISED ACCOUNTING PRACTICE

Summary of Fund Accounts prior to the “New Standards” with the Implementation Requirements

Former Fund Accounting Statement of Financial Position	Implementation Process	Description of Implementation Process and Reference to these Guidelines	New Standards of Financial Position
STATUTORY FUNDS			
Capital Development Fund Land Trust Fund Public Improvement Fund Endowment Fund Other Statutory Funds	Transfer to Asset Financing Reserve	The various statutory funds are initially amalgamated and then an Asset Financing Reserve (AFR) created.	Asset Financing Reserve
Refer to Reserves for a discussion on the Asset Financing Reserve (AFR).			
Housing and Townships Development Fund	Retain	The only statutory fund that has been retained is the Housing Development Fund, in terms of legislation.	Housing and Townships Development Fund
HOUSING AND TOWNSHIPS DEVELOPMENT FUND			
Overview of old and new scheme housing			
<p>Legislation governing the provision of housing that was effective from 1 April 1998 changed the basis of providing housing. Prior to 1 April 1998, there was an “old scheme” that was primarily based on the provision of soft loans for municipalities to undertake the provision of housing. The legislation terminating “old scheme” business is not clearly drafted and there are diverse interpretations of its application in numerous municipalities around the country.</p>			

**Former Fund Accounting
Statement of Financial Position**

Implementation Process

**Description of Implementation Process and
Reference to these Guidelines**

**New Standards of Financial
Position**

The “new scheme” is based on a subsidy that is used to provide houses. Typically, municipalities act as developers on behalf of the provincial government. These subsidies are usually included in municipality capital budgets, although the houses built are never under the control of the municipality. Only the infrastructure, such as roads, will be under the control of the municipality and ultimately capitalised.

Old scheme housing

There is no common interpretation amongst municipalities of the housing legislation disbanding the old scheme. The loans that were extinguished by government on 1 April 1998 must be ring-fenced and used to provide housing in future through the mechanism of the Housing Development Fund. The Housing Development Fund is a statutory fund and must be disclosed on the Statement of Financial Position as such. Municipalities should continue operating a housing operating account. Municipalities should include “old scheme” transactions in the Statement of Financial Performance, including revenue earned and expenses incurred.

New expenses, such as the depreciation of housing rental units and the provision for bad debts, will need to be included in the Statement of Financial Performance. This means that the transactions of the “old scheme” should be budgeted for in the same manner as other activities of the municipality from both an operating and capital perspective. When preparing financial statements, the net revenue or expenditure included in the municipality’s Statement of Financial Performance will be transferred to the Housing Development Fund through the Statement of Changes in Community Wealth. In this way, there will be compliance with the housing legislation and the new accounting standards.

New scheme housing

Housing developments based on the new scheme are operational transactions. The subsidy received from the provincial government is revenue and must be included in the Statement of Financial Performance. Houses developed under the new scheme are not under the control of the municipality and the subsidy is therefore not a capital receipt. Development costs are an expense, excluding those that relate to infrastructure and community assets that will be under the control of the municipality, which must be capitalised. Municipalities up to now have not been budgeting for new scheme housing correctly. In terms of GAMAP, operational transactions will have to be included in the income statement and budgeted for accordingly. This may have practical implications owing to the long-term nature of such projects, but this will need to be managed.

Processing of Township Development Suspense Account

Property developments that have been undertaken and funded by the municipality also need to be identified and recognised in the annual financial statements. In most cases these developments will be done through a Township Development Suspense Account, which is included in the Statement of Financial Position as either a net debit or credit balance. All transactions, including the cost of development and revenue from the sales of properties, are included in the Township Development Suspense Account. Where possible, the costs relating to each separate development should be

Former Fund Accounting Statement of Financial Position	Implementation Process	Description of Implementation Process and Reference to these Guidelines	New Standards of Financial Position
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identified together with the number of stands in such development. In this way a unit cost can be determined for each stand. Where these costs cannot be accurately determined, an estimate should be made.

A key step is to identify all the infrastructure costs that will remain the property of the municipality. These should be identified and transferred to property, plant and equipment. Again, if there are inadequate accounting records, estimates based on fair value should be made and used to record these items of property, plant and equipment. These amounts must be excluded from the unit cost per stand. Once this has been done, the Township Development Suspense Accounts can be unbundled.

This is done by determining a cost per unsold stand and transferring that amount to a property development account. This will be based on the unit cost per unsold stand. The balance on the Township Development Suspense Account, after the transfer of the cost of unsold units, should be transferred to the Statement of Financial Performance. This will reflect whether historically surpluses or losses have been incurred on previous property developments. After implementation, proceeds from the sale of stands will be recorded as revenue. The unit cost of any stand sold will be recorded as an expense, resulting in either a surplus or deficit on disposal.

Conclusion

Once accounting standards have been implemented, there will be budgetary implications arising from housing activities. These transactions will need to be budgeted for. From an accounting perspective, housing will be included in the Statement of Financial Performance.

[Reference: Chapter 7 of the National Treasury Guidelines for the Implementation of Accounting Standards of Generally Recognised Accounting Practice]

RESERVES			
Maintenance of Roads	Reverse	The general rule is that an Asset Financing Reserve (AFR) must be created. The Asset Financing Reserve (AFR) is established from existing statutory funds, excluding the Housing Development Fund. In terms of the new capital accounting model, the Future Depreciation Reserves must be created.	Asset Financing Reserve (AFR) Future Depreciation Reserves
Developers Contribution	Transfers to liabilities or include in unappropriated surplus		

Principles for establishment of the Asset Financing Reserve

The principles for establishing the Asset Financing Reserve (AFR) are that all existing funds established in terms of the provincial ordinances should be consolidated into one reserve that will be called the Asset Financing Reserve (AFR). The Asset Financing Reserve (AFR) is equivalent to a savings account and only has one asset, namely a dedicated bank or investment account. Municipalities must first establish an Asset Financing Reserve (AFR) on the implementation of accounting standards. Once a draft Asset Financing Reserve (AFR) has been established, adjustments are made for internal loans or advances that are still outstanding at the date of implementation (which is explained in these guidelines) and the residual balance is then compared with cash or investments attributable to the Asset Financing Reserve (AFR). Where there is insufficient cash or investments, then the balance of the Asset Financing Reserve (AFR) is written down to the balance of cash or investments.

The Asset Financing Reserve (AFR) can be increased by transferring amounts from unappropriated surpluses to the Asset Financing Reserve (AFR) through the Statement of Changes in Community Wealth. There are no restrictions on the amount that can be transferred, except that there must be sufficient cash or investments to support the increased balance of the Asset Financing Reserve (AFR).

It should be noted that those municipalities that have a significant Asset Financing Reserve (AFR) would be in a better position to finance development. Those municipalities that have cash-flow challenges will not be able to have an Asset Financing Reserve (AFR). Instead, it is likely that such municipalities will have to increase their bad debt provision using the non-cash portion that will be transferred out of the Asset Financing Reserve (AFR) on implementation.

The process to establish the Asset Finance Reserve (where there is no Consolidated Loan Fund)

The following process map should be used to establish the Asset Financing Reserve E (AFR) where there is not a Consolidated Loans Fund (CLF)

Steps Procedure:

- One Aggregate the existing statutory funds into one account. This is merely the aggregation of similar account balances.
- Two Debit the accumulated fund by an amount equivalent to the internal investments outstanding.
- Three Reverse the internal investments balance against the various internal loans or advances accounts in the borrowing services.
- Four Compare the total of the accumulated fund with the balance of cash or investments attributable to the Asset Financing Reserve (AFR). Reverse the “unfunded” balance to the unappropriated surplus.

Former Fund Accounting
Statement of Financial Position

Implementation Process

Description of Implementation Process and
Reference to these Guidelines

New Standards of Financial
Position

The process to establish the External Finance Fund (where there is no Consolidated Loan Fund)

Where there is no Consolidated Loan Fund (CLF), the process to establish the External Finance Fund (EFF) is relatively simple. Based on the work done on preparing a Fixed Assets Register and Unbundling Loans Redeemed and Other Capital Receipts, it will be possible to determine the external loans outstanding that have been utilised to finance property, plant and equipment and what is unspent.

[Reference: Chapter 5 of the National Treasury Guidelines for the Implementation of Accounting Standards of Generally Recognised Accounting Practice

Refer to Property, Plant and Equipment for more information on the Asset Financing Reserve]

Rationalisation of liability provisions and reserves

In terms of the definitions of liabilities, liabilities can be created only where there is a present obligation. On implementation, municipalities will need to reverse excessive liability provisions. In addition, liability provisions should be raised where previously no- or inadequate provisions had been created. The National Treasury also discourages the excessive use of reserves, as this is misleading to users and could result in taxation in advance of need. The only reserve that is permitted, in addition to those created in terms of the new capital accounting model, is the Self-Insurance Reserve.

Principles of rationalisation of liability provisions and reserves

In order to assist municipalities, rationalize existing provisions and reserves, examples are provided below with an explanation as to the treatment of such provision or reserve on implementation.

Example of Provision or Reserve	Principles to be Applied	Treatment of Implementation
Provision for future capital expenditure.	This is taxation in advance of need. There is no present obligation and therefore should not be retained.	This provision must be reversed to the unappropriated surplus on implementation.

Former Fund Accounting Statement of Financial Position	Implementation Process	Description of Implementation Process and Reference to these Guidelines	New Standards of Financial Position
Provision for future operating expenditure. This could include provisions for legal fees, maintenance, valuation roll preparation and audit fees, amongst others.	This is taxation in advance of need. Unless there is a present obligation, such provisions should not be retained.	These provisions must be reversed to unappropriated surpluses on implementation.	
Developers' contributions.	In certain cases, there is a present obligation. The municipality may have charged a developer an amount that must be used to construct an item of property, plant or equipment by a certain date. In such instances, there is a present obligation and such amounts must be disclosed as liabilities. However, there are also developers' contributions that do not represent an obligation. In other words, the municipality may have levied a charge but there is no obligation to construct a specific item of property, plant or equipment. These amounts should not be shown as a provision or reserve.	Where there are present obligations, amounts should be classified as liabilities and included in the Statement of Financial Position. Where there are no obligations, the amounts should be transferred to the Asset Financing Reserve (AFR) if there is sufficient cash; or transferred to unappropriated surpluses.	
Unspent conditional grants	In certain provinces these amounts are shown as trust monies. Where there is an obligation, unspent grants must be shown as a liability on the Statement of Financial Position.	Unspent conditional grants must be shown as a liability until the conditions of the grant have been met.	

Former Fund Accounting Statement of Financial Position	Implementation Process	Description of Implementation Process and Reference to these Guidelines	New Standards of Financial Position
Tariff stabilisation reserves	This is taxation in advance of need. There is no present obligation and it should therefore not be retained.	These provisions must be reversed to unappropriated surpluses on implementation.	
Self-insurance funds or reserves	These are permitted and can be retained as a reserve.	This will be included under reserves on implementation.	
Staff bursary or loan guarantee funds or reserves	This is taxation in advance of need. There is no present obligation and it should therefore not be retained.	These funds or reserves must be reversed to unappropriated surpluses on implementation.	
Endowments	These represent revenue and should no longer be accounted for in reserves.	This fund or reserve should be transferred to the Asset Financing Reserve (AFR) if there is sufficient cash or transferred to unappropriated surpluses.	
Parking levies, dog licences and other statutory funds.	These represent revenue and should no longer be accounted for in reserves.	These funds or reserves should be transferred to the Asset Financing Reserve (AFR) if there is sufficient cash; or transferred to unappropriated surpluses.	
Staff Leave	There is a present obligation to staff for leave accrued but not yet taken or encashed.	A liability should be raised equal to the liability to staff.	

(Reference: Chapter 5 of the National Treasury Guidelines for the Implementation of Accounting Standards of Generally Recognised Accounting Practice)

Former Fund Accounting Statement of Financial Position	Implementation Process	Description of Implementation Process and Reference to these Guidelines	New Standards of Financial Position
Tariff Stabilisation	Reverse		
Unspent Grants	Transfer to Liabilities		
Self-Insurance	Retain	The only reserve that may be retained is the self-insurance reserve.	Self-insurance Reserve
(Reference: Chapter 5 of the National Treasury Guidelines for the Implementation of Accounting Standards of Generally Recognised Accounting Practice)			
Surplus/Accumulated Deficit	Unchanged		Surplus/Accumulated Deficit
<p>Conclusion:</p> <p>The concept of rationalising excessive provisions and reserves from an annual financial statement perspective is to promote consistency and to assist users in understanding the financial performance of the municipality. However, from a budgeting perspective, it is important that municipalities make provision for future expenditure that will ensure financial sustainability. However, this must be done in a transparent manner. These amounts will be classified as unappropriated surpluses in the annual financial statements.</p> <p>(Reference: Chapter 6 of the National Treasury Guidelines for the Implementation of Accounting Standards of Generally Recognised Accounting Practice)</p>			

Former Fund Accounting Statement of Financial Position	Implementation Process	Description of Implementation Process and Reference to these Guidelines	New Standards of Financial Position
TRUST FUNDS			
Unspent Government Grants	Transfer to Liabilities	Traditionally the terminology “monies held in trust” with specific reference to government grants, was disclosed as a trust fund. This is incorrect, as unspent government grants are liabilities and should be disclosed as such. Only where the municipality is a trustee of a trust in terms of the trust deed should the terminology “trust funds” be used. These “trust funds” are disclosed as liabilities in the new standards format Statement of Financial Position.	Liabilities Trust Fund – where municipality is trustee in terms of a trust deed.
Trusts where municipality is trustee	Retain		

There is a misconception regarding the use of trust funds in municipalities nationally. In the Western Cape in particular, trust funds are established for unspent provincial grants or where municipalities have an obligation to undertake an activity at a future date. This accounting treatment is not correct, as these municipalities are not trustees nor has a formal trust fund been established.

The general rule is that where a municipality is appointed trustee in terms of a trust deed, then the assets and wealth must be recorded in a trust fund and shown as such in the Statement of Financial Position. Municipalities should maintain separate accounting records for the trust, but will include the assets and wealth of the trust fund on its Statement of Financial Position, because, as trustee, the assets of the trust vest in the municipality concerned in its capacity as trustee.

Interest earned on trust fund investments cannot be included in the municipality’s Statement of Financial Performance, as the interest accrues to the trust. There is a need for municipalities to review existing trusts disclosed as such in the balance sheet. Only where there is a trust deed and the municipality is trustee should trust funds be disclosed in the Statement of Financial Position as a trust.

Former Fund Accounting Statement of Financial Position

Implementation Process

Description of Implementation Process and Reference to these Guidelines

New Standards of Financial Position

Examples of where municipalities may need to reclassify certain transactions that up to now have been classified as trusts are as follows:
Capital grants from the provincial government: These should be classified as Unspent Capital Receipts in terms of the new capital accounting model. **Mayor’s Charity/Christmas Funds/Flood Relief:** If funds collected are deposited in the municipal bank accounts, the municipality has an obligation to the Fund. This obligation should be raised as a liability. **National Treasury Financial Management and Restructuring Grants:** These are operational grants and should be credited to revenue once the conditions have been fulfilled. There is an obligation to the National Treasury until the conditions of the grant have been met.

(Reference: Chapter 6 of the National Treasury Guidelines for the Implementation of Accounting Standards of Generally Recognised Accounting Practice)

PROPERTY, PLANT AND EQUIPMENT

<p>PPE at Cost</p> <p>Less: Loans Redeemed and other Capital Receipts</p> <p>Loans Redeemed</p> <p>Contributions from revenue</p> <p>Government Grants</p> <p>Public Contributions</p>	<p>Unchanged</p> <p>Unbundled</p>	<p>A comprehensive asset register must be prepared. Once prepared, loans redeemed and other capital receipts must be reversed. Loans Redeemed and Other Capital Receipts must initially be used for finance backlog depreciation and establish the future depreciation reserves and the residual balance remaining must be transferred to either the Asset Finance Reserve or unappropriated surpluses.</p>	<p>PPE at cost</p> <p>Less Accumulated Depreciations</p>
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The New Capital Accounting Model

The principle of surplus cash financing is that a municipality uses its own internal cash flow to acquire items of property, plant and equipment. Once acquired, these items of property, plant and equipment are depreciated. Cash flows may be generated from the disposal of property, plant and equipment, working capital management and operating surpluses.

**Former Fund Accounting
Statement of Financial Position**

Implementation Process

**Description of Implementation Process and
Reference to these Guidelines**

**New Standards of Financial
Position**

The principle of external loans is that external loans are ring-fenced using a memorandum system of accounting called the External Financing Fund (the EFF). The External Financing Fund enables a municipality to:

- demonstrate compliance with the Municipal Finance Management Act; and
- plan and manage external loans so that sufficient cash is generated to repay external loans on the redemption date.

The principles of government grant and public contribution funded items of property, plant and equipment is that there should be no capital cost included in tariffs by using this source of financing. The grant or contribution is used to offset depreciation charges that will emanate from the relevant item of property, plant and equipment being brought into use through the establishment of a Future Depreciation Reserve. There is also a need to comply with GAMAP 9, which requires that the value of government grant funded property, plant and equipment be recognised in the Statement of Financial Performance as revenue when the conditions of the grant have been met.

Until the conditions of the grant have been met, a liability is recognised that is equal to the value of the grant or conditions with which there must still be compliance. Thereafter, a transfer is made to revenue when the conditions have been met. An amount equal to the grant is appropriated to a Future Depreciation Reserve through the Statement of Changes in Community Wealth. Thereafter, the Future Depreciation Reserve is used to offset the annual depreciation charge, again using the Statement of Changes in Community Wealth.

If the item of property, plant or equipment is disposed of prior to being fully depreciated, the balance in the Future Depreciation Reserve, which will equal the carrying value of the item of property, plant or equipment disposed of, will be transferred to unappropriated surpluses through the Statement of Changes in Community Wealth.

The principle of using the Asset Financing Reserve is that there is a recognition that municipalities may have to set aside cash for the future acquisition of items of property, plant and equipment and that double taxation risks exist. The Asset Financing Reserve is a mechanism to be used in this regard that mitigates the risk of double taxation. In addition, upon implementation of GAMAP, most municipalities will have existing funds. As explained later in these guidelines, these existing funds will be consolidated into the Asset Financing Reserve.

**Former Fund Accounting
Statement of Financial Position**

Implementation Process

**Description of Implementation Process and
Reference to these Guidelines**

**New Standards of Financial
Position**

To prevent double taxation, when the Asset Financing Reserve is used to finance the acquisition of property, plant and equipment, a transfer is made from the Asset Financing Reserve (AFR) to a Future Depreciation Reserve. This Future Depreciation Reserve will be used to offset the depreciation charge of the relevant items of property, plant and equipment.

The principles of the new capital accounting model are not significantly different from those of the original capital accounting model. There has been significant capacitation on the old capital accounting model and a publication and other documentation can be obtained from the National Treasury. These documents will provide practitioners with more detailed information on the old standards and provide a sound basis to understanding the new standards capital accounting model as explained.

Municipalities have to ensure that all external loans will be repaid on the redemption date. As a result, cash flow will have to be managed to ensure that sufficient cash is accumulated for this purpose. This will be at the discretion of the municipality. In certain cases, municipalities may open externally invested sinking funds so that there will be sufficient cash available. In such a scenario there will therefore not be a need to accumulate monies internally in the External Financing Fund.

Municipalities have to ensure that the periods for which external loans are taken out are affordable. If the external loan period corresponds with the useful life of the item of property, plant or equipment purchased with the proceeds of such loan, theoretically the depreciation charge will assist in generating the necessary cash to repay the loan. However, if the loan period is shorter, then the municipality must have the ability to generate significant additional cash through its revenue-raising mechanisms.

Interest paid has been excluded from these examples. Interest paid is an expense and must be included in the Statement of Financial Performance accordingly. The External Financing Fund does not earn external interest received. Any interest receipts on the External Financing Fund bank/investment accounts must be credited to the Statement of Financial Performance.

In certain cases, government may require the municipality to incur the cost of purchase, which is then refunded, or alternatively government may donate an item of property, plant or equipment. These different scenarios do not detract from the capital accounting model; ultimately the grant will be recorded as revenue when there has been compliance with the conditions of the grant and a Future Depreciation Reserve will be created, equal to the value of the grant received, from which to offset future depreciation.

Where an item of property, plant or equipment is donated, either by government or the public, then the item is initially recorded at fair value. The corresponding entry will be a credit to revenue. It should be noted that until the conditions of a grant have been met, an obligation must be raised.

Former Fund Accounting
Statement of Financial Position

Implementation Process

Description of Implementation Process and
Reference to these Guidelines

New Standards of Financial
Position

The purpose of this financing model is to ensure that there is not double-taxation. The annual depreciation offsets from the Future Depreciation Reserve: Asset Financing Reserve (AFR) will achieve this objective. The Asset Financing Reserve (AFR) does not earn interest. Any interest earned will be credited to revenue and included in the Municipality's Statement of Financial Performance. The Asset Financing Reserve (AFR) must always be cash-backed. When the cash of the Asset Financing Reserve (AFR) is used for other purposes, then the Asset Financing Reserve (AFR)'s Accumulated Fund must be reduced accordingly. The Accumulated Fund will be reduced by the shortfall in cash and the unappropriated surplus increased accordingly, using the Statement of Changes in Community Wealth in the annual financial statements.

[Reference: Chapter 2 of the National Treasury Guidelines for the Implementation of Accounting Standards of Generally Recognised Accounting Practice]

Unbundling Loans Redeemed and Other Capital Receipts

Loans Redeemed and Other Capital Receipts must be used to fund backlog depreciation and, where appropriate, to establish the Future Depreciation Reserves that are now an integral part of the new capital accounting model. The Fixed Assets Register must include information on the financing sources of property, plant and equipment as explained in chapter 3. It should therefore be possible to reconcile Loans Redeemed and Other Capital Receipts to the total of property, plant and equipment.

The following reconciliation should be performed to prove that Loans Redeemed and Other Capital Receipts do reconcile to property, plant and equipment:

- Total Property, Plant and Equipment
- Less: Loans Redeemed and Other Capital Receipts
- Less: External Loans Outstanding
- Less: Internal Loans or Advances Outstanding
- Equals Zero

If this reconciliation does not equal zero, then an adjustment must be made to Loans Redeemed and Other Capital Receipts to balance the reconciliation to zero. The corresponding entry will be processed to the unappropriated surplus account. As part of this process, it is important to ensure that all external

loans are allocated to items of property, plant and equipment. It is important that all internal loans are also allocated to items of property, plant and equipment. This should be possible, as most municipalities have Internal Advances Registers with details of items of property, plant and equipment financed. It is also important to allocate loans redeemed to specific items of property, plant and equipment when undertaking this process.

Overview of the unbundling process

An overview of the unbundling of LROCR (Loans Redeemed and Other Capital Receipts) is provided in the table below.

Component of Loans Redeemed and Other Capital Receipts	Process for Assets funded from this	Convert to Accumulated Depreciation	Treatment of Residual Balance
Revenue contributions	Determine backlog accumulated depreciation	Allocate corresponding balance of revenue contributions to accumulated depreciation	Balance of revenue contributions to unappropriated surplus
Public contributions/donations	Determine backlog accumulated depreciation	Allocate corresponding balance of public contributions/ donations to accumulated depreciation to prevent double taxation	Balance of public contributions/ donations to Future Depreciation Reserve
External Loans Redeemed	Determine backlog accumulated depreciation (should be in agreement with balance on external loans redeemed account if loan period corresponds with asset lives)	Allocate external loans redeemed to accumulated depreciation to prevent double taxation	Not applicable
Internal Loans Redeemed	Determine backlog accumulated depreciation (should be in agreement with balance on internal loans redeemed account if loan period corresponds with asset life)	Allocate internal loans redeemed to accumulated depreciation	Not applicable

Component of Loans Redeemed and Other Capital Receipts	Process for Assets funded from this	Convert to Accumulated Depreciation	Treatment of Residual Balance
Government grants	Determine backlog accumulated depreciation	Allocate corresponding balance of government grants to accumulated depreciation	Balance of government grants to Future Depreciation Reserve
Other sources of funding Note: Historically, municipalities have different financing sources dependent on the requirements of the provincial ordinances or fund accounting practices prevailing when the item of property, plant and equipment was acquired.	Determine backlog depreciation	Allocate balance of funding to accumulated depreciation	Balance to either Future Depreciation Reserve if externally funded or unappropriated surplus if internally funded

Once backlog depreciation has been calculated in the Fixed Assets Register, a transfer is made from the Loans Redeemed and Other Capital Receipts to finance the backlog depreciation. In addition, a transfer is made to the relevant Future Depreciation Reserve in respect of the carrying value/net book value of assets financed from government grants and public contributions. The residual value remaining in LROCR is then transferred to the unappropriated surplus and essentially represents those items of property, plant and equipment that were financed from revenue contributions and other previously permitted asset financing sources; or it represents the redemption portion of external and internal loans included in expenditure where loan payment periods are shorter than the economic life of the asset.

Loan Redemption Funds

A Loan Redemption Fund (LRF) is mandatory in certain provinces and is used to accumulate funds to repay loans on their due date. Municipalities contribute to the fund from the income statement annually. The LRF always has to be cash-backed. When GAMAP is implemented, the LRF has to be unbundled, as it cannot be retained. The amount in the LRF relates to a loan, which in turn can be linked to an asset. When external loans are matched to assets and backlog depreciation is calculated, there will be no amount in loans redeemed (where there is an LRF). Instead, backlog depreciation will have to be funded from the accumulations in the LRF.

In practice, instead of debiting Loans Redeemed and Other Capital Receipts to recover backlog depreciation, the debit will be processed to the LRF.

Conclusion

Once the financing information has been obtained and recorded in the Fixed Assets Register, it is possible to unbundle Loans Redeemed and Other Capital Receipts as illustrated in the examples above.

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ANNEXURE C – GUIDELINES FOR THE IMPLEMENTATION OF ACCOUNTING STANDARDS OF GENERALLY RECOGNISED ACCOUNTING PRACTICE ISSUED WITH MFMA CIRCULAR 18 (JUNE 2005)

Process to establish the Capital Replacement Reserve, the Capitalisation Reserve and the External Financing Fund

Principles behind the establishment of the capital replacement reserve

The principles of establishing the Capital Replacement Reserve (CRR) is that all existing funds established in terms of the Provincial Ordinances be consolidated into one reserve, which will be called the CRR. The CRR is equivalent to a savings account and has only one asset, namely a dedicated bank or investment account.

Upon the implementation of the standards municipalities must firstly establish a CRR. Once a draft CRR has been established, adjustments are made for internal loans or advances that are still outstanding at the date of implementation and the residual balance is then compared to cash or investments attributable to the CRR.

Where there is insufficient cash or investments, then the balance of the CRR is written down to the balance of cash or investments through the accumulated surplus/ deficit in the Statement of Changes in Net Assets.

The CRR can be subsequently increased by transferring amounts from the accumulated surplus to the CRR through the Statement of Changes in Net Assets. There are no restrictions on the amount that can be transferred except that there must be sufficient cash or investments to support the increased balance of the CRR.

It should be noted that those municipalities that have a significant CRR would be in a better position to finance development. Those municipalities that have cash-flow challenges will not be able to have a CRR.

The capitalisation reserve

It is important to understand the concept of the Capitalisation Reserve before establishing the CRR. The reason is that the various statutory funds that were created in terms of the Ordinances were permitted to make internal loans or advances to the various services such as the Electricity, Water and Rates and General Services. These internal loans were repayable and interest was charged on these loans. When establishing the CRR, which is the amalgamation of the existing statutory funds, internal loans will represent a part of the assets of the CRR.

The carrying value of property, plant and equipment financed by internal loans will have to be compared to the balance of the internal loans outstanding at the date of the implementation of the standards. If there are differences, an adjustment should be made to the balance of the internal loans outstanding and to the accumulations of the CRR to ensure that the internal loans are in agreement with the carrying value.

These internal loans in the CRR are reversed against the liability reflected in the borrowing services that had received the internal loans. This will result in the assets of the CRR being less than the accumulations in the CRR by the amount of the reversal of the internal loans.

An amount is the “before transferred from the CRR”, equal to the “internal loans reversed”, to a “Capitalisation Reserve”. The Capitalisation Reserve therefore represents amounts previously accumulated that were recovered from consumers through rates and tariffs and that have been used to acquire items of Property, Plant and Equipment. These amounts are therefore not available to be used for any other purpose. In addition, this Reserve aims to promote consumer equity by ensuring that consumers are not subject to double taxation when the items of property, plant and equipment acquired through internal loans are depreciated upon the introduction of standards.

The accounting entries relating to the establishment of the Capitalisation Reserve and the offsetting of depreciation are illustrated further in this Chapter.

The process to establish the CRR (where there is no CLF)

The following process map should be used to establish the CRR where there is no Consolidated Loans Fund (CLF).

One Aggregate the existing statutory funds into one account. This is merely the aggregation of similar account balances

Two Debit the accumulated account by an amount equivalent to the internal investments/internal advances outstanding and credit the Capitalisation Reserve.

Three Reverse the internal investments/internal advances balance against the various internal loans or advances accounts in the borrowing services

Four Compare the total of the accumulated fund to the balance of cash or investments attributable to the CRR. Reverse the “unfunded” balance to the accumulated surplus

The process to establish the EFF (where there is no CLF)

Where there is no CLF, the process to establish the EFF is relatively simple. Based on the work done on preparing a Fixed Assets Register and Unbundling Loans Redeemed and Other Capital Receipts, it will be possible to determine the external loans outstanding, what has been utilised to finance property, plant and equipment and what is unspent.

Unbundling the CLF to establish the EFF and CRR

The CLF is a technically complex fund and therefore its unbundling will be equally technically complex. There are various methods used by municipalities to both establish and maintain their CLF. This guideline cannot include relevant guidance on all the different methods in use but rather explains the unbundling process by using a comprehensive example of a CLF.

Municipalities will therefore need to adapt the unbundling guidance in this Chapter to their own specific circumstances.

Firstly, classify internal advances between external loans and internal capital accumulations of the different funds. If the outstanding external loan amount is not fully covered by the outstanding internal advances the shortfall will be covered by allocating external investments to the EFF. The remaining portion of external investments of the old CLF is now earmarked for the CRR. Consolidate all accumulations of the different funds to form a draft CRR. Decrease (debit) the draft CRR with the amount of the outstanding internal advances made from internal capital funds via the CLF and create (credit) the Capitalisation Reserve. Follow the same process with any outstanding advances made directly from the individual funds. The Capitalisation Reserve should balance with the total carrying value of the assets that have been financed by the internal advances as the depreciation on these assets will be offset from this reserve in future. The draft CRR (after the internal advances have been deducted) will now have to be compared with the cash and external investments. If there is a cash shortfall the CRR will be decreased (debited) with the amount of the shortfall, which will be transferred (credited) to Accumulated Surplus/Deficit.

Conclusion

The establishment of the CRR and EFF, particularly where there is a CLF, is a technically difficult exercise. It is important that the new principles of accounting for property, plant and equipment are fully understood so that the objectives of the unbundling process can be conceptualised.

It is also important that municipalities prepare a draft CRR even if there is not likely to be sufficient cash or investments. It is only once the CRR has been established that the amount of cash or investments required can be determined. If the CRR does have sufficient cash or investments, the balance of the CRR must be retained as this will be a cost-effective source of financing in future years.

It should be noted that these implementation entries could only be prepared once the various balances in the statutory funds have been finalised in the year preceding implementation.