



## Funding a municipal budget

This circular provides further guidance to municipalities and municipal entities on funding a budget and seeks to clarify and reinforce the intent of budget related provisions in the MFMA. It complements earlier guidance on funding the budget contained in MFMA circular 28.

The mayor, municipal manager and chief finance officer must ensure that the concepts discussed in this circular are applied for the 2007/08 medium term budget to comply with the requirements of the MFMA. However, by virtue of the technical nature of issues addressed in this circular it is imperative that the reader has a sound understanding and working knowledge of financial management.

One of the key elements of the budget process is ensuring that the budget is appropriately funded. To do this, various MFMA requirements must be understood and complied with, including section 18 (Funding of expenditure), section 19 (Capital projects) and section 21 (Budget preparation process). Each of these sections should be reviewed when working through this circular.

To clarify the reforms and intent of the MFMA, this circular provides guidance in the following areas, including a practical example in Annexure A:

1. The move to accrual based financial management - implications for funding a budget
2. The distinction between "a balanced budget" and "a funded budget"
3. Full disclosure of revenue and cash
4. Clarity on "realistically anticipated revenues to be collected" - MFMA s 18
5. Clarity on "funds not committed for any other purpose" - MFMA s 18 & 19
6. Realistic estimation of expenditure - implications for funding a budget
7. Clarity on the concept of a "credible budget" - MFMA s 21

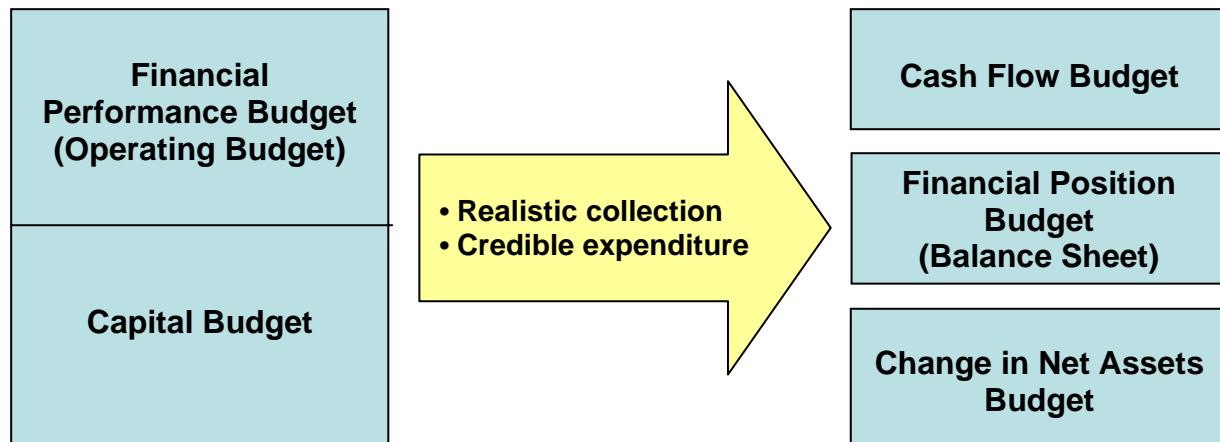
### 1. Accrual based financial management

A major reform area in municipal financial management has been the move away from fund-based financial management to accrual-based. When correctly implemented, the new approach will facilitate sustainable financing of the budget over the medium term.

MFMA Circular 28 provided guidance on this matter, and the content of "Funding the Budget" and a "Credible Budget" explained in page 2 of that circular should be revisited by municipalities when finalising the budget. It should be especially noted that a realistic, credible, viable and sustainable budget is achieved through simultaneous alignment of projected financial performance, financial position and cash flows. Concerns with accrual items and depreciation can only be considered in this overall context.

Circular 28 indicated that the budget documentation must include GRAP compliant information. Specifically, a Financial Performance budget, a Financial Position budget, a Cash Flow budget and a budget for Changes in Net Assets must be included in the supporting

documentation to the budget. The proposed Budget regulations planned to be released for comment later this year will require these aspects to form part of the “annual budget” for the purposes of council approval of budget schedules. The diagram below shows the linkages with the main budget schedules. The naming convention used achieves consistency with financial reporting terminology with alternate terminology in brackets. Requirements for revenue and expenditure by ‘vote’ will be satisfied within the schedules.



The focus on accrual based financial management will assist decision-makers with comprehensive information when funding strategies are discussed prior to adoption of the budget. Discussions on proposed borrowing, the utilisation of grants, and setting of appropriate tariffs to ensure ongoing sustainability of existing and proposed services will be strengthened. Information will also assist in the review of ratepayers/consumers contributions towards services, for the years covered by the medium term revenue and expenditure framework.

The example contained in Annexure A will assist with understanding the complex relationships, between operating/capital budget, financial performance, financial position and cash transactions that need to be analysed when developing a fully-funded compliant budget.

Effective budget management should be guided by a financial plan and related policies, as was previously described in MFMA Circular 28 under the subject of “Fiscal Overview” (section 5.5) and should also be reviewed to appreciate that financing the budget should be realised within the financial policy framework determined by each municipality.

## 2. Balanced budget v funded budget

In the past, municipal budgets have been concerned with demonstrating that a budget is balanced from a funds perspective. That is, funds going out were balanced with funds coming in, plus any funds already held in reserve from previous years. The guidance presented in this circular requires that the budget should be managed in a full accrual manner reflecting a transparent budget and accounting system approach.

The MFMA through section 18 requires that the budget can only be funded by realistically anticipated revenue to be collected and cash-backed accumulated funds from previous years, not committed for other purposes.

The capital budget may be funded by cash-backed current year surplus in the Financial Performance budget, including capital grants and other contributions, cash-backed accumulated funds from previous years not committed for other purposes, and borrowing. The

term “cash-backed” is explained further under heading 5 below and in the example contained in Annexure A.

The following highlights the need for a thorough analysis to determine whether or not the budget is funded in accordance with the MFMA.

A Financial Performance budget surplus/deficit in itself is not an indication of a ‘funded’ budget, due to items such as capital grants, depreciation and provisions.

Let's assume, for example, that a municipal Financial Performance budget shows a deficit. This deficit would not exist if budgeted depreciation was not included<sup>1</sup>. Trying to apply the past mindset of a “balanced budget” to the Financial Performance budget may result in a view that consumer charges will need to be increased to cover the depreciation. This may not be the case, since a deficit on the Financial Performance budget does not necessarily mean that the budget is not funded. Therefore, further analysis will be required by the municipality to obtain the correct picture.

In another example, let's assume that the Financial Performance budget shows a surplus and that the surplus is mainly due to a large capital grant<sup>2</sup>. This assumes that without the grant there would be a large deficit shown on the Financial Performance budget. It is clear that a surplus does not always indicate a positive financial situation and again, further analysis must be undertaken to understand the full picture.

Similarly, an increase in cash held, shown on the Cash Flow budget is not in itself an indication of a compliant ‘funded’ budget due to items such as payments due to creditors or cash set aside to meet cash-backed reserve requirements.

Let's otherwise assume that the Cash Flow budget is showing an increase in cash and cash equivalents over the year. Consider the situation where this is mainly due to unpaid creditors for capital projects and that if these were removed the Cash Flow budget would show a decrease in “cash and cash equivalents”<sup>3</sup>. In the absence of any other information, it would appear that while cash is expected to increase during the year, the budget may not be funded in accordance with section 18 of the MFMA.

In the above examples, it was illustrated that in order to understand whether the budget was adequately funded or not, in accordance with the MFMA, there will be required simultaneous analysis of the budget for Financial Performance, Financial Position, Cash Flow, and Changes in Net Assets.

### 3. Full disclosure of revenue and cash

Some municipalities may have misinterpreted previous advice and budgeted for revenue net of uncollectible debts. The intent of the MFMA is for the budget to reflect the full amount of revenue budgeted to be billed, accrued or otherwise levied or revenue directly received (e.g. bus fares and recreation facility admission fees), to ensure that the municipality and other readers of the budget are fully aware of the total revenue contributions by its community and

<sup>1</sup> This example is illustrated in the 2007/08 year in Part 1 of Annexure A.

<sup>2</sup> This example is illustrated in the 2008/09 year in Part 1 of Annexure A.

<sup>3</sup> This example is illustrated in the 2007/08 year in Part 2 of Annexure A.

revenue from other sources. Therefore, revenue shown in the Financial Performance budget must be the full amount of revenue to be “raised” or “billed”, accrued or otherwise directly received.

Realistically anticipated amounts for the provision for doubtful and bad debts (amounts billed that are not expected to be collected) must be budgeted separately under “expenditure” and not netted out from the “revenue” line. A municipality’s revenue policy should provide guidance on the methodology for determining the doubtful/bad debt provision taking into consideration recent collection trends.

For effective budgeting and management of revenues, municipalities must also ensure that the number of consumer accounts is reconciled with property records and metering information to ensure that all consumers are billed appropriately. Full disclosure will enhance policy development, regular financial performance monitoring and improved service delivery.

#### 4. Realistic revenues – (s 18)

Let us consider what the MFMA intends when it refers to “realistically anticipated revenues to be collected”. The combination of the terms “revenue” and “to be collected” is supporting the assertion that the full amount of accrued revenue is disclosed in the Financial Performance budget and cash be “realistically collected”.

The term “realistically anticipated” requires the budget to take into consideration previous years performance, and the likelihood of whether all revenue sources will be realised. If there are expected improvements planned, these must be supported by changes in policies and or practices that are proven to deliver the proposed benefits. Such improvements must be estimated conservatively with a view that all of the promised gains may not result in additional or increased collections immediately.

The term “to be collected” does not just refer to the current year’s revenue. It requires a forecast of monies to be collected relating to revenue from both the current Financial Performance budget and a forecast of monies to be collected from previous years revenues (e.g. collections from debtors in arrears based on historical performance). These forecasts should be included in the Cash Flow budget and be tracked separately to aid with preparation of annual and monthly cash flow forecasts. Monthly revenue projections (SDBIP) should be reconciled to the monthly cash flow forecasts to account for the differences in collection and timing assumptions.

Associated with the determination of realistic revenue is the assessment of the level of arrear debtors shown in the Financial Position budget. Municipalities should ensure that arrear debt is not inflated by ongoing inclusion of debtors that are not collectible, regardless of whether an adequate bad debt provision has been included. This will require council to approve policies to regularly, at least once per annum, review and address this issue.

Capital expenditure must only be included in the budget if there is certainty that financing will be secured.

Failure to realise funding will require an adjustment budget to reduce expenditure. Examples of overly optimistic revenue forecasts include excessive increases in property rates and service charges or donor grants with no guarantee of being received by the municipality. Budgeted capital expenditure funded by external funds should be reconciled and supported by appropriate written evidence, such as the Division of Revenue Act, National or Provincial gazettes, agency agreements, or legally binding contractual agreements with third parties.

## 5. Not committed for any other purpose – (s 18 & 19)

MFMA sections 18 and 19 provide that the Financial Performance (operating) and Capital budgets can be “funded from cash-backed accumulated funds and from previous years surpluses not committed for other purposes”.

“Committed for other purposes” implies that there has been a council resolution to allocate the funds for a specific purpose, to be used for a fixed contractual obligation, whether as part of a medium term revenue and expenditure framework or by reserving the accumulated surplus.

Future commitments must be analysed as part of the preparation of the Cash Flow budget to ensure that an accumulated surplus is genuinely cash-backed.

The process of determining which part of the accumulated surplus is cash-backed is achieved by analysing the cash resources available to a municipality and the commitment requirements to ensure that sufficient cash and investments are provided as shown in the example contained in Annexure A.

## 6. Realistic estimation of expenditure

To ensure a budget is appropriately funded there is also a requirement for expenditure estimations in the Financial Performance and Capital budgets, and the expenditure effect on the Cash Flow and Financial Position budgets, to be realistic.

The budget must be based on the planned service delivery objectives in the IDP, as expressed annually in the SDBIP, take into consideration previous years and recent performance, assumptions regarding price movements for inputs to the budget (for example, inflation), other economic and demographic factors. If there are expected efficiencies planned, these must be supported by changes in policies and or practices that are proven to deliver the proposed benefits. Such improvements must also be estimated conservatively as all of the promised efficiency gains or expenditure reductions may not be achieved immediately. If budgeted expenditure is underestimated, budgeted revenue may not be sufficient to fund the planned level of service delivery.

## 7. Credible budget – (s 21)

The mayor must ensure that the budget tabled in full council for consultation (at least 90 days prior to the start of the budget year) is credible. In other words it must be capable of implementation if it was approved, as tabled. One of the main reasons for this is to ensure that meaningful and effective consultation with the community, on the tabled budget, is executed. Municipalities are encouraged to use this opportunity to consult effectively with communities on service delivery improvements. In this way the budget can be used as a mechanism to “contract” with the community/residents on realising the budgeted revenue to achieve service delivery objectives.

A credible budget must be consistent with the IDP and achievable in terms of service delivery and performance targets; revenue and expenditure projections must be realistic; and the implementation of the budget must improve the financial viability of the municipality (refer to page 2 of MFMA Circular 28 for detailed discussion).

While municipalities may have tabled their budgets already, it is imperative that approved budgets are reviewed for credibility and consistency with this circular.

## Detailed review of the example - Annexure A

It is advisable to work through the example contained in Annexure A in more detail. The explanatory notes and cross references between the circular and the Annexure A are intended to make the exercise easier.

The main purpose of this example is to illustrate and explain:

- A 'Financial Performance' budget result (surplus/deficit) as shown in Part 1
- A 'Cash Flow' budget result as shown in Part 2
- Revenue and cash flow interrelationship, especially the effect of collection rates on cash receipt assumptions and providing for bad/doubtful debts as shown in Parts 1 and 2
- The impact of cash flow timing on budget assumptions; e.g. the difference between capital 'expenditure' and capital 'payments' as shown in Part 2
- Improved forecasting of funding for the capital programme as shown in Parts 2 and 3
- Reconciling available cash and investments to determine the amount of reserves and accumulated surplus that is cash backed to ensure compliance with MFMA section 18(1)(b) as illustrated in Part 3

## Conclusion

This circular provides specific guidance to municipalities and municipal entities on MFMA requirements for funding the budget and seeks to clarify and reinforce the intent of budget related provisions in the MFMA, including the notion that tariff increases should not be a consequence of financial management reforms.

While budgets should already have been tabled, the final approved medium term budget for 2007/08 should comply, to the maximum extent possible, with the guidance issued in this circular. If not, municipalities when submitting their budgets to National Treasury and the relevant provincial treasury must provide supporting information on measures taken to address any shortcomings by providing a timetable for remedial action.

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## Annexure A – Budget funding reconciliation

PART 1 - Budgeting for Financial Performance					
Description	Ref	Budget Year	Budget Year	Budget Year	
		2007/08 R'000	2008/09 R'000	2009/10 R'000	
<b>OPERATING REVENUE</b>					
Property rates	A	500,000	525,000	551,250	
Service charges	A	1,300,000	1,378,000	1,460,680	
Rental of facilities and equipment	A	18,000	19,800	21,780	
Interest earned - external investments	D	31,000	32,550	34,178	
Interest earned - outstanding debtors	D	39,000	40,950	42,998	
Fines	B	14,000	15,400	16,940	
Licences and permits	B	6,000	6,600	7,260	
Revenue for agency services	B	150,000	165,000	181,500	
Government Grants and subsidies - Operating	E	200,000	290,000	300,000	
Government Grants and subsidies - Capital	F	400,000	440,000	484,000	
Other revenue	B	100,000	110,000	121,000	
Public contributions, donated & contributed PPE	B,L	33,000	36,300	39,930	
Gains on disposal of PPE	B	9,000	12,000	15,000	
<b>Total Operating Revenue</b>		<b>2,800,000</b>	<b>3,071,600</b>	<b>3,276,515</b>	
<b>OPERATING EXPENDITURE</b>					
Employee related costs		600,000	636,000	674,160	
Remuneration of Councillors		12,000	12,720	13,483	
Bad & doubtful debts	M	91,000	96,000	102,000	
Collection costs		10,000	10,500	11,025	
Depreciation		350,000	380,000	410,000	
Repairs and maintenance	N	200,000	212,000	329,401	
Finance charges		110,000	175,400	205,000	
Bulk purchases		564,000	598,000	610,000	
Contracted services		550,000	560,000	592,445	
Grants and subsidies		3,000	3,000	3,000	
General expenses		320,000	240,000	220,000	
<b>Total Operating Expenditure</b>		<b>2,810,000</b>	<b>2,923,620</b>	<b>3,170,515</b>	
<b>Operating Surplus/(Deficit)</b>		<b>(10,000)</b>	<b>147,980</b>	<b>106,000</b>	

PART 2 - Budgeting for Cash Flow				
Description	Ref	Budget Year 2007/08 R'000	Budget Year 2008/09 R'000	Budget Year 2009/10 R'000
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>				
<b>Receipts</b>				
Cash receipts from ratepayers and other	A,B	1,997,000	2,124,000	2,259,000
Cash receipts from government - operating	E	200,000	290,000	300,000
Cash receipts from government - capital	F	400,000	440,000	484,000
Interest received	D	68,000	74,800	82,280
<b>Payments</b>				
Cash paid to suppliers and employees		(2,136,000)	(2,197,000)	(2,314,000)
Finance charges paid		(100,000)	(100,000)	(100,000)
<b>NET CASH FROM/USED OPERATING ACTIVITIES</b>		<b>429,000</b>	<b>631,800</b>	<b>711,280</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>				
<b>Receipts</b>				
Proceeds on disposal of PPE		19,000	66,000	36,000
Decrease in current/non-current debtors	C	3,000	6,200	
Decrease in inventory		20,000	20,000	
Decrease in non-current receivables	C	10,000	10,000	
<b>Payments</b>				
Increase in inventory				(15,000)
Increase in long term investments			(50,000)	(50,000)
Purchase of property, plant and equipment	I,J	(550,000)	(800,000)	(800,000)
<b>NET CASH FROM/USED INVESTING ACTIVITIES</b>		<b>(498,000)</b>	<b>(747,800)</b>	<b>(829,000)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>				
<b>Receipts</b>				
Borrowing long term/refinancing	K	200,000	300,000	350,000
Increase in consumer deposits		10,000	16,000	17,720
<b>Payments</b>				
Repayment of borrowing	K	(50,000)	(50,000)	(50,000)
<b>NET CASH FROM/USED FINANCING ACTIVITIES</b>		<b>160,000</b>	<b>266,000</b>	<b>317,720</b>
<b>NET INCREASE/ (DECREASE) IN CASH HELD</b>		<b>91,000</b>	<b>150,000</b>	<b>200,000</b>
Cash/cash equivalents at the year begin:		<b>259,000</b>	<b>350,000</b>	<b>500,000</b>
Cash/cash equivalents at the year end:		<b>350,000</b>	<b>500,000</b>	<b>700,000</b>

PART 3 - Reconciliation of reserves and commitments backed by cash/investments					
Description	Ref	Budget Year 2007/08 R'000	Budget Year 2008/09 R'000	Budget Year 2009/10 R'000	
Reserves to be backed by cash	G	500,000	650,000	700,000	
Capital budget creditors unpaid at year end	J	100,000	150,000	350,000	
<b>Total commitments:</b>		<b>600,000</b>	<b>800,000</b>	<b>1,050,000</b>	
<b>Total cash and investments available</b>					
Cash/cash equivalents at the year end	H	350,000	500,000	700,000	
Long term investments held		250,000	300,000	350,000	
<b>Cash and investments available</b>		<b>600,000</b>	<b>800,000</b>	<b>1,050,000</b>	
<b>Explanation notes/references</b>					
(A) It is assumed that 95% of 'billed and accrued' revenue will be collected/received in each year					
(B) 100% of other revenue items will be collected and received. PPE gains and public contributions are non-cash					
(A)(B) For example, in 2007/08 'Cash Received' relating to (A) and (B) revenue items is calculated as follows. [(R500m + R1,300m + R18m) * 95% + (R14m + R6m + R150m + R100m) * 100%] = approximately R1,997m					
(C) Proceeds of arrear collections (current and non-current debtors), as well as other non-current receivables collected					
(D) Interest received comprises 95% of interest on debtors and 100% of investment interest. For example, in 2007/08 interest received is calculated as [(R39m * 95%) + R31m] = approximately R68m					
(E) All operating grants will be received and spent					
(F) All capital grants will be received and spent					
(G) The municipality has Reserves of <b>R500m, R650m and R700m</b> (in each of the 3 years) on the Financial Position budget that need to be backed by cash					
(H) The Financial Position Budget indicates <b>R250m, R300m and R350m</b> of long term investments are available to meet long term commitments					
(I) Capital budgeted and appropriated expenditure is <b>R650m, R850m and R900m</b> . Cash flows differ - see (J) below.					
(J) Cash flows for capital budget are <b>R550m, R800m and R800m</b> due to creditors expected to be paid after the expenditure is incurred					
(K) Capital budgeted expenditure of <b>R650m</b> is funded by R400m in grants, R200m from borrowing and R50m from the forecast accumulated surplus. In 2008/09 the budget of <b>R850m</b> is to be funded by R440m in grants, R300m in borrowing and R110m of accumulated surplus. In the 3rd year the Capital budget of <b>R900m</b> is funded by R484m in grants, R350m borrowing and R66 of accumulated surplus. The municipality borrowed using a zero coupon bond, with interest and principal payments deferred until maturity, so needs to put funds aside each year until maturity of the loan.					
(L) Public contributions, donated & contributed PPE are assumed to be donated assets					
(M) Bad/doubtful debts have been provided at 5% of billable revenue					
(N) The municipality had a strategy of increasing repairs and maintenance expenditure to address backlogs in repairs					
<b>Is the municipality's budget appropriately funded? - YES</b>					
- Cash receipts projections are realistic as the Cash Budgets were reduced in line with expected levels of collection					
- Bad/doubtful debts have been adequately provided for which is consistent with (A) that 95% of billed and accrued revenue will be collected/received in each year					
- Financial Performance Budget shows a deficit and includes capital grants and donated assets indicating a larger underlying accrual accounting deficit, but the budgeted result is after providing for depreciation					
<b>Conclusion:</b> the budget has been funded and complies with MFMA because forecast cash outflow obligations are supported by cash inflows, taking into account any commitments at year end that need to be backed by cash. In other words, there are sufficient current and non-current investment funds and realistically anticipated revenue collections to meet expenditure budgets and ensure commitments are backed with cash. The ratepayers and consumers are also making a reasonable contribution towards the economic resources being consumed. A longer term financial plan is needed to understand whether sustainability is achieved; e.g. ability to meet loan repayments or affordability of tariff charges. It is assumed that a detailed analysis of the Financial Position budget was undertaken to determine other long term obligations needing to be progressively funded, resulting in the establishment of the necessary reserve funds (including future loan repayment commitments)					