MUNICIPAL FINANCE MANAGEMENT ACT

Guidelines for the implementation of accounting standards of generally recognised accounting practice

Local government

National Treasury
May 2004

ISBN: (To come)

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Table of Contents

Chapter 1: Background and introduction **1**

The status of accounting standards 1
Implementation dates 1
Exemptions and delays 2
Standards to be taken into account on implementation 3
Accounting standards implementation principles 3
Overview of the standards implementation process 4
Illustration of the standards implementation process 5

Chapter 2: The new capital accounting model **9**

The principles of the new capital accounting model 9
Example of financing from surplus cash 10
Example of financing from external loans 11
Financing from grants and public contributions 12
Financing from the Asset Financing Reserve (AFR) 13

Chapter 3: Property, plant and equipment **15**

Preparation of a detailed Fixed Asset Register 15
Producing inventories of property, plant and equipment 15
Determining values of property, plant and equipment at the date of implementation 15
Determining the opening balances of accumulated depreciation on implementation 16
Global amounts 16
Incomplete or missing acquisition dates 17
Vague asset descriptions 17
Incomplete financing sources 17
Long-life assets 18
Conclusion 19

Chapter 4: Unbundling Loans Redeemed and Other Capital Receipts **21**

Unbundling of Loans Redeemed and Other Capital Receipts 21
Overview of the unbundling process 21
Example of unbundling Loans Redeemed and Other Capital Receipts 22
Loan Redemption Funds 24
Conclusion 24

Chapter 5: Process to establish the External Financing Fund and Asset Financing Reserve **25**

Principles for establishment of the Asset Financing Reserve 25
The process to establish the AFR (where there is no CLF) 25
The process to establish the EFF (where there is no CLF) 26
Unbundling the CLF to establish the EFF and AFR 27
Conclusion 29

Chapter 6: Process to reclassify provisions and reserves **31**

Rationalisation of liability provisions and reserves 31
Principles of rationalisation of liability provisions and reserves 31
Conclusion 32

Chapter 7: Housing and township developments **33**

Overview of old scheme and new scheme housing 33
Old scheme housing 33
New scheme housing 33
Processing of Township Development Suspense Account 34
Conclusion 34

Chapter 8: Other standards implementation issues **35**

Trust funds 35
Bad debt provisions 35
Consolidation of municipal entities 36
Internal interest and loan redemption capital charges 36

Chapter 9: Summary of the implications of the standards post-implementation **37**

Post-implementation matters to consider 37
GRAP 1: Presentation of financial statements 37
GRAP 3: Accounting policies, changes in accounting estimates and errors 37
GAMAP 19: Provisions, contingent liabilities and contingent assets 37
GAMAP 12: Inventories 38
GAMAP 7: Accounting for investments in associates 38
GAMAP 6: Consolidated financial statements and accounting for controlled entities 38
GAMAP 9: Revenue
GAMAP 4: The effects of changes in foreign exchange rates 38
GRAP 2: Cash Flow Statements 38
GAMAP 8: Financial reporting of interests in joint ventures 39
GAMAP 17: Property, plant and equipment 39

Chapter 10: Summary of the standards implementation process **41**

Compliance with the accounting standards 41
Early implementation of standards 41

Chapter 1: Background and introduction

The status of accounting standards

The Constitution requires the National Treasury to introduce standards of generally recognised accounting practice (GRAP) for all spheres of government. The Accounting Standards Board (ASB) has been established to make recommendations on standards of GRAP to the Minister of Finance. The Board has approved a number of accounting standards and these will be submitted to the Minister for approval and gazetting. The ASB has also approved local government accounting standards (referred to in this document as "the standards") as interim GRAP applicable to municipalities and municipal entities only. These standards are available on the ASB's website (www.asb.co.za).

Over time, the local government accounting standards that have been approved by the ASB will be replaced by standards of GRAP. Although old local government standards have been in the public domain since 1998, the ASB has updated the standards to take into account developments that have occurred in accounting nationally and internationally since 1998. The purpose of updating the old standards is to ensure that there will not be significant differences between the standards and subsequent GRAP standards that will be issued in the next few years. This will ensure that there is no high risk of change should municipalities adopt the new standards.

The ASB is responsible for developing and issuing accounting standards. The National Treasury is responsible for developing uniform budget formats and accounting standards implementation guidelines and for issuing specimen financial statements in accordance with the accounting standards issued by the ASB.

The conversion from the current fund accounting framework to new standards involves a number of implementation processes. The purpose of this guideline is to identify these processes and to explain the different activities to be performed as part of each process.

These guidelines also explain the accounting treatment that has been developed by the National Treasury in respect of the financing of certain items of property, plant and equipment as well as the establishment of internal funds and reserves. These new requirements, which are referred to as the new capital accounting model, are also illustrated in the specimen financial statements that have been issued by the National Treasury.

Implementation dates

As part of the planning for the implementation of the Municipal Finance Management Act (MFMA), the National Treasury, during February and March 2004, conducted a survey of municipal finance management capacity, after researching material from Statistics SA, the Demarcation Board and the Department of Provincial and Local Government.

The survey, which involved the distribution of questionnaires to all 284 municipalities (category A – 6 metropolitan municipalities, category B – 231 local municipalities and category C – 47 district municipalities), focused on the following, among other things:

- Type of municipality, by category
- Budget size in rand terms
- Content, quality and timeliness of submission of budgets, financial statements and annual reports
- Level of sophistication of budgeting and reporting systems
- Appointment of qualified personnel in senior management
- Duration of period spent on the Financial Management Grant Pilot Programme
- Availability of an international advisor
- Allocation of the Municipal Infrastructure Grant

The above information was utilised to categorise municipalities into three capacity levels, namely:

- High capacity – relatively high scores
- Medium capacity – medium scores over 21 points
- Low capacity – low scores below 21 points or did not return surveys

The table below summarises the results of the survey. The dates in the table are the implementation dates for the accounting standards. The MFMA implementation strategy indicates the names of the municipalities that fall into each category.

Capacity	**Number of municipalities**	**Implementation date**
High	50	1 July 2004 (2004/05 FY)
Medium	106	1 July 2005 (2005/06 FY
Low	128	1 July 2006 (2006/07 FY)
Total	**284**	

For the purpose of consistency, the accounting standards implementation dates were aligned with the MFMA implementation strategy.

Exemptions and delays

Section 92 of the Public Finance Management Act (PFMA), Act 1 of 1999, grants the Minister the power to exempt an institution, or categories of institutions to which the Act applies, by notice in the *Government Gazette*, from specific provisions of the Act, including the production of annual financial statements in compliance with standards of generally recognised accounting practice. The period of the exemption will be determined in the notice. With regard to accounting standards, exemptions will relate to Chapter 11 of the PFMA.

On the other hand, the MFMA, Act 56 of 2003, requires the categorisation of municipalities. Section 177 deals with delays and exemptions from implementation of a specific provision of the Act. In this instance, this relates to delays and exemptions from implementation of sections 121 to 134 of the MFMA. A period and conditions of the delay or exemption will be determined by notice issued by the Minister in the *Government Gazette*.

The following process should be followed in applying for the exemption or delay:

- An application for delay and/or exemption from implementing the standards by an entity or category of entities as indicated in the table above must be made by the accounting officer(s)/municipal manager(s) of the entity or category of entities and must be made in writing.
- The accounting officer/municipal manager must provide reasons for the exemption/ delay.

- The accounting officer must provide the National Treasury with plans of action instituted to implement the standards. Such plans must reflect the timeframes and milestones that will be achieved.
- The application must be addressed to: The National Treasury, Chief Director: Local Government, Private Bag X115, PRETORIA, 0001.

Standards to be taken into account on implementation

The table below summarises the status of the standards as at the date of these implementation guidelines. The table lists the new standards that replace the old standards as well as the new standards of GRAP.

Old standard reference	Title	New standard reference
GAMAP 000	Framework for the Preparation and Presentation of Financial Statements	New GRAP being developed
GAMAP 100	Presentation of Financial Statements	GRAP 1
GAMAP 101	Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies (now Accounting Policies, Changes in Accounting Estimates and Errors)	GRAP 3
GAMAP 102	Accounting for Leases in the Financial Statements of Lessees	Withdrawn
GAMAP 103	Provisions, Contingent Liabilities and Contingent Assets and Events occurring after the Balance Sheet Date (now Provisions, Contingent Liabilities and Contingent Assets)	GAMAP 19
Not a separate statement	Events after the Balance Sheet Date	Withdrawn
GAMAP 104	Inventories	GAMAP 12
GAMAP 105	Accounting for Investments in Associates and Subsidiaries (now Accounting for Investments in Associates)	GAMAP 7
Not a separate statement	Consolidated Financial Statements and Accounting for Controlled Entities	GAMAP 6
GAMAP 106	Revenue	GAMAP 9
GAMAP 107	The Effects of Changes in Foreign Exchange Rates	GAMAP 4
GAMAP 108	Lessor Accounting	Withdrawn
GAMAP 109	Research and Development Costs	Withdrawn
GAMAP 110	Retirement Benefit Costs	Withdrawn
GAMAP 111	Cash Flow Statements	GRAP 2
GAMAP 112	Financial Reporting of Interests in Joint Ventures	GAMAP 8
GAMAP 113	Property, Plant and Equipment	GAMAP 17
GAMAP 114	Accounting for Statutory Funds, Reserves and Capital Receipts	Withdrawn

Accounting standards implementation principles

The National Treasury is aware that the implementation of the standards can be a time-consuming and costly exercise. Much depends on the status of accounting records that have been maintained historically. The two demarcation processes have added to the challenge.

A pragmatic outlook is necessary and where information is not available municipalities will need to adopt an approach that will enable implementation but will not result in the spending of considerable funds. It is, however, necessary to produce annual financial statements that are as accurate as possible to ensure that there is appropriate accountability by municipalities as envisaged in the Constitution.

These guidelines will provide guidance on how to adopt a pragmatic approach without detracting from the responsibility of each municipality to ensure that it produces accurate financial statements taking into account its own individual and specific circumstances.

Overview of the standards implementation process

The implementation of the standards involves converting the Statement of Financial Position at the beginning of the financial year from fund accounting to the new standards formats. It should be noted that the conversion process must take place at the commencement of the financial year in which implementation is to be undertaken. It cannot be done mid-year, or the municipality will not be able to prepare proper annual financial statements.

The implementation process will therefore require two Statements of Financial Position to be prepared. The first, which will be based on the fund accounting principles, will be prepared as at 30 June, which will be the financial year ending pre-standards implementation. This Statement of Financial Position will form part of the annual financial statements of the municipality and will be audited accordingly.

The second Statement of Financial Position will be based on the new standards formats and will be prepared as at 1 July. This Statement will record the adjustments that have to be made to the fund accounting balance sheet to comply with the standards formats. It also provides comparative amounts for the first set of accounting standards format financial statements that will be prepared once the standards have been implemented. It should be noted that no adjustments should be made to the Statement of Financial Performance (Income Statement) on implementation of the standards. Changes in the recognition and measurement of revenue and expenses will be recorded in the Statement of Financial Performance post-implementation of the standards and these are explained in more detail in Chapter 9 of these guidelines

A table has been prepared that illustrates examples of account balances that will typically appear in the Statement of Financial Position of a municipality. A summary of the implementation process is described briefly in Chapter 2 in this guideline. A new standards–format-compliant Statement of Financial Position is also included in the table, so that users of these guidelines can assess the implications of the standards.

Illustration of the standards implementation process

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			***Statutory fund***
Capital Development Fund Land Trust Fund Public Improvement Fund Endowment Fund Other Statutory Funds Housing Development Fund	Transfer to AFR Transfer to AFR Transfer to AFR Transfer to AFR Transfer to AFR Retain	The various statutory funds are initially amalgamated and then an Asset Financing Reserve (AFR) created. The only statutory fund that has been retained is the Housing Development Fund. Refer to Chapter 7 for the operations of the Housing Development Fund. Refer to Chapter 5 on establishing the AFR. In terms of legislation, the only statutory fund is the Housing Development Fund.	Housing Development Fund
Reserves			***Reserves***
Maintenance of Roads Developers Contributions Tariff Stabilisation Unspent Grants Self-Insurance Unappropriated Surplus/ Accumulated Deficit	Reverse Transfer to liabilities or include in unappropriated surplus Reverse Transfer to Liabilities Retain Unchanged	The general rule is that an AFR must be created as set out in Chapters 2 and 5. The AFR is established from existing statutory funds, excluding the Housing Development Fund, as illustrated above. In terms of the new capital accounting model, Future Depreciation Reserves must be created as set out in Chapter 2. The only other reserve that may be retained is the Self-Insurance Reserve, as explained in Chapter 6. It should be noted that Chapter 6 explains the general principles regarding the reclassification of provisions and reserves.	Asset Financing Reserve (AFR) Future Depreciation Reserves Self-Insurance Reserve Unappropriated Surplus/ Accumulated Deficit
Trust funds			***Liabilities – trust funds***
Unspent government grants Trusts where municipality is trustee	Transfer to Liabilities Retain	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.	 Trust funds (where municipality is trustee in terms of a trust deed)

Former fund accounting Statement of Financial Position	Implementation process	Description of implementation process and reference to these guidelines	New GAMAP Statement of Financial Position
External loans			***External loans***
External loans	Unchanged	The concept of an EFF has been introduced, as illustrated in Chapters 2 and 5. However, the EFF is a memorandum account and the components of the EFF are shown on the face of the Statement of Financial Position under appropriate headings.	External Loans

Current liabilities			***Current liabilities***
Trade creditors Payments received in advance Bank overdrafts Short-term portion of long-term debt Unspent government grants and public contributions Staff leave Consumer deposits	Unchanged Unchanged Unchanged Unchanged Transfer from trust funds or provisions and reserves Unchanged Reclassified from non-current to current liabilities	There are not fundamental changes in the determination of current liabilities. Consumer deposits are reclassified from long-term liabilities (non-current) to current liabilities. In terms of the new capital accounting model described in Chapter 2, unspent conditional government grants are recognised as a liability until the conditions of the grant have been met. Thereafter, such grants are recognised as revenue, and when used to acquire an item of property, plant and equipment, a Future Depreciation Reserve is created, again as described in Chapter 2. The same principles apply to unspent public contributions. Staff leave is an accrual and the full staff leave obligation at year-end must be raised as a current liability, regardless of how the obligation will be settled at a future date.	Trade creditors Payments received in advance Bank overdrafts Short-term portion of long-term debt Unspent government grants Staff leave Consumer deposits

Property, plant and equipment (PPE)			***Property, plant and equipment (PPE)***
PPE at cost Less Loans Redeemed and other Capital Receipts • Loans redeemed • Contributions from revenue • Government grants • Public contributions	Unchanged Unbundled Unbundled Unbundled Unbundled	A comprehensive Fixed Assets Register must be prepared as set out in Chapter 3. Once the Fixed Assets Register has been prepared, Loans Redeemed and Other Capital Receipts must be reversed. Loans Redeemed and Other Capital Receipts must initially be used to finance backlog depreciation and establish the Future Depreciation Reserves referred to in Chapter 2 and the residual balance remaining must be transferred to either the AFR or unappropriated surpluses. The unbundling process is explained in Chapter 4.	PPE at cost Less accumulated depreciation

Former fund accounting Statement of Financial Position	Implementation process	Description of implementation process and reference to these guidelines	New GAMAP Statement of Financial Position
Non-current assets			***Non-current assets***
Investments Debtors Township Development Suspense	Unchanged Unchanged Reclassified	There is no change in the classifications of non-current assets, except where a municipality has previously used a Township Development Suspense Account. The cost of unsold developments must be determined and classified as either non-current, where the intention is to sell off such developments over a period exceeding 12 months, or inventory, if the intention is to dispose of such developments within 12 months. Infrastructure costs previously included in the Suspense Account must be transferred to PPE. Refer to Chapter 7 for further information on unbundling Township Development Suspense Accounts.	Investments Debtors Property developments
Current assets			***Current assets***
Consumer debtors Inventory Current portion of long-term debtors Short-term investments Cash and bank balances	Unchanged Unchanged Unchanged Unchanged Unchanged	There are no changes affecting current assets emanating from the implementation of the standards. However, there is an expectation that appropriate provisions will be made for irrecoverable consumer debtors' balances and inventory obsolescence. Refer to Chapter 8 for guidance on this matter.	Consumer debtors Inventory Current portion of long-term debtors Short-term investments Cash and bank balances

Chapter 2: The new capital accounting model

The principles of the new capital accounting model

The new capital accounting model has been developed for the following sources of financing to acquire items of property, plant and equipment:

- Surplus cash
- External loans
- Government grants and public donations
- Asset Financing Reserve

The key principles of each of these financing methods are explained in this chapter. Examples have also been developed to illustrate each of the financing methods.

The new capital accounting model has been developed taking the following into account:

- The new budget reforms
- The Municipal Finance Management Act
- Community equity
- Consistency in financial statement preparation

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.

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 EFF 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 from 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, on 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.

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 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 explained in this chapter.

Example of financing from surplus cash

Assume the following example:

A municipality has strong internally generated cash flows and decides to acquire an item of property, plant or equipment costing R1 000. The item of property, plant or equipment has a useful life of 5 years. The item of property, plant or equipment is acquired on 1 July 2003.

The following accounting entries will be processed in the accounting records in the year ending 30 June 2004:

CASH					
			1	Payment	1 000

PROPERTY, PLANT AND EQUIPMENT					
1	Purchase	1 000			

DEPRECIATION					
2	Annual depreciation	200			

ACCUMULATED DEPRECIATION					
			2	Annual depreciation	200

Explanatory notes

1. This is the amount paid for the purchase of the item of property, plant or equipment.
2. This is the annual depreciation (R1000 ÷ 5).

Example of financing from external loans

Assume the following example:

A municipality raises a loan of R1 000 to acquire an item of property, plant or equipment. The loan is repayable after 5 years. The item of property, plant or equipment has a useful life of 5 years. The item of property, plant or equipment is acquired on 1 July 2003.

The following accounting entries will be processed in the accounting records in the year ending 30 June 2004:

EFF: EXTERNAL LOANS					
			1	Loan received	1 000

EFF: BANK/INVESTMENT ACCOUNT					
2	Loan received	1 000	3	Advance made	1 000
8	Repayment of advance	200			

EFF: ADVANCES TO SERVICES					
3	Advance made	1 000	8	Repayment of advance	200

SERVICES: BORROWING FROM EFF					
7	Repayment of advance	200	4	Advance received	1 000

GENERAL BANK ACCOUNT					
4	Advance received	1 000	5	Purchase	1 000
			7	Repayment of advance	200

PROPERTY, PLANT AND EQUIPMENT					
5	Purchase	1 000			

DEPRECIATION					
6	Annual depreciation	200			

ACCUMULATED DEPRECIATION					
			6	Annual depreciation	200

Explanatory notes

1. This is the external loan received.
2. These loan proceeds must be paid into a separate bank account. This will enable the municipality to demonstrate compliance with the Municipal Finance Management Act.
3. When the external loan is used for the purchasing of an item of property, plant or equipment, the separate EFF bank account is credited. An advance is raised for the service that will use the external loan proceeds to acquire the item of property, plant or equipment.
4. The service that will use the external loan to acquire an item of property, plant or equipment will raise the obligation to the EFF (advance received) and deposit the money received from the EFF in its own bank account (general bank account).
5. This is the amount paid for the purchase of the item of property, plant or equipment.
6. This is the annual depreciation (R1000 ÷ 5).
7. This entry is for illustrative purposes only. Ultimately the external loan must be repaid and cash transferred from the services general bank account to the EFF bank account so

that sufficient cash will be available in the EFF bank account to repay the loan on redemption. A municipality will transfer cash to the EFF based on its own cash flow management. In this example, the municipality will repay the advance from the EFF based on the depreciation charged on the item of property, plant or equipment financed from the external loan. The services bank account is credited and the advance from the EFF reduced.

8. The EFF acknowledges that it has been repaid from the service. It increases the EFF bank account and reduces the advance made to the service.

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. There will therefore not be a need to accumulate monies internally in the EFF in such a scenario.

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 generate 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 EFF does not earn external interest received. Any interest receipts on the EFF bank/investment accounts must be credited to the Statement of Financial Performance.

Financing from grants and public contributions

Assume the following example:

A municipality is given a government grant of R1 000 on the condition that it acquires an item of property, plant or equipment. The item of property, plant or equipment has a useful life of 5 years. The item of property, plant or equipment is acquired on 1 July 2003.

The following accounting entries will be processed in the accounting records in the year ending 30 June 2004. As there is no difference between government grants and public contributions, government grants have been used in these examples:

GOVERNMENT GRANTS: OBLIGATIONS					
3	Transfer to revenue	1 000	1	Cash received	1 000

UNUTILISED GRANTS: BANK/INVESTMENT ACCOUNT					
1	Cash received	1 000	2	Purchase	1 000

REVENUE					
			3	Transfer from obligations	1 000

PROPERTY, PLANT AND EQUIPMENT					
2	Purchase	1 000			

DEPRECIATION					
4	Annual depreciation	200			

ACCUMULATED DEPRECIATION					
			4	Annual depreciation	200

UNAPPROPRIATED SURPLUS					
5	Transfer	1 000	6	Depreciation offset	200

FUTURE DEPRECIATION RESERVE: GOVERNMENT GRANTS					
6	Depreciation offset	200	5	Transfer	1 000

Explanatory notes

1. This is the grant received. As the conditions have not been met, an obligation is raised. The unspent grant proceeds must be paid into a separate bank or investment account to ensure that the cash is not used for unauthorised purposes.
2. The cash is then used to purchase the item of property, plant or equipment.
3. When the item of property, plant or equipment has been constructed, the conditions of the grant have been met. The grant is therefore transferred from obligations to revenue in terms of GAMAP 9.
4. This is the annual depreciation (R1000 ÷ 5).
5. At the end of the financial year, a transfer is made from the unappropriated surplus, equal to the grant received, to a Future Depreciation Reserve. This reserve will be used to offset the future depreciation relating to the item of property, plant and equipment financed by government grants. This will achieve consumer equity.
6. This is the annual offset of depreciation that will be processed annually until the item of property, plant or equipment has been fully depreciated.

The example above shows what happens when cash is transferred to a municipality to acquire an item of property, plant or equipment. 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.

Financing from the Asset Financing Reserve (AFR)

Assume the following example:

A municipality decides to acquire an item of property, plant or equipment costing R1 000 from its AFR. The item of property, plant or equipment has a useful life of 5 years. The item of property, plant or equipment is acquired on 1 July 2003.

The following accounting entries will be processed in the accounting records in the year ending 30 June 2004:

AFR: ACCUMULATED FUND					
2	Utilised to finance property, plant and equipment	1 000			

AFR: BANK/INVESTMENT ACCOUNT					
			1	Purchase	1 000

FUTURE DEPRECIATION RESERVE: AFR					
4	Depreciation offset	200	2	Utilised to finance property, plant and equipment	1 000

PROPERTY, PLANT AND EQUIPMENT					
1	Purchase	1 000			

DEPRECIATION					
3	Annual depreciation	200			

ACCUMULATED DEPRECIATION					
			3	Annual depreciation	200

UNAPPROPRIATED SURPLUS					
			4	Depreciation offset	200

Explanatory notes

1. Cash available in the AFR bank/investment account is used to purchase the item of property, plant or equipment.
2. A corresponding transfer is made from the AFR Accumulated Fund to the Future Depreciation Reserve: AFR. The balance of this Future Depreciation Reserve will be used to offset future depreciation charges to prevent double taxation. The reason is that the AFR Accumulated Fund has previously been funded from citizens.
3. This is the annual depreciation (R1000 ÷ 5).
4. This is the annual offset of depreciation that will be processed annually until the item of property, plant or equipment has been fully depreciated.

The purpose of this financing model is to ensure that there is not double-taxation. The annual depreciation offsets from the Future Depreciation Reserve: AFR will achieve this objective.

The AFR does not earn interest. Any interest earned will be credited to revenue and included in the Municipality's Statement of Financial Performance.

The AFR must always be cash-backed. When the cash of the AFR is used for other purposes, then the 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.

Chapter 3: Property, plant and equipment

Preparation of a detailed Fixed Asset Register

GAMAP 17 must be studied in order to gain an understanding of the accounting treatment and disclosure information relating to property, plant and equipment.

In order to be in a position to implement GAMAP 17, a detailed Fixed Assets Register must be prepared and maintained. The reason is that GAMAP 17 requires that most items of property plant and equipment be depreciated over their economic life.

The following information should be included in the Fixed Assets Register as a minimum:

- Acquisition dates of all items of property, plant and equipment.
- Clear descriptions of individual items of property, plant and equipment.
- Depreciation rates as set out in GAMAP 17.
- Historical cost of individual items of property, plant and equipment
- Department or service that uses or controls the item of property, plant or equipment.
- Identification reference for physical verification and asset management purposes.
- Original funding source of individual items of property, plant and equipment.

All items of property, plant and equipment must also be categorised into infrastructure, community, heritage, investment properties and other assets as explained in GAMAP 17. These categories are important from a disclosure perspective.

There is a separate section on long-life assets (infrastructure) in this chapter. There will be different implementation requirements for infrastructure and guidance is provided separately from short-life and movable property, plant and equipment.

Producing inventories of property, plant and equipment

The preparation of the Fixed Assets Register should be based on an inventory of property, plant and equipment. In respect of movable items of property, plant and equipment, this will provide an accurate basis for preparing a new Fixed Assets Register or updating an existing register.

It is likely that municipalities will encounter situations where there are items of property, plant and equipment that are not in the Fixed Assets Register or vice versa. Appropriate adjustments will have to be made to the Fixed Assets Register prior to the date of GAMAP implementation.

Determining values of property, plant and equipment at the date of implementation

The values of property, plant and equipment must be disclosed in the financial statements at fair value. There are two ways to determine fair value:

- Method 1: Historical cost less accumulated depreciation

- Method 2: The value at which the item of property, plant and equipment could be exchanged between a willing and knowledgeable buyer and a willing and knowledgeable seller

Municipalities that are preparing their Fixed Assets Register may have to use both methods. Initially municipalities should use method 1 as far as possible and thereafter apply method 2. These guidelines will provide information on both methods.

Determining the opening balances of accumulated depreciation on implementation

Backlog depreciation should be calculated on existing items of property, plant and equipment, wherever possible, from the date of acquisition of the item of property, plant or equipment to the date of GAMAP implementation. This backlog depreciation will be the opening balance of accumulated depreciation as at the date of implementation of GAMAP. The only exception is land and heritage assets, which will not be depreciated. These guidelines provide guidance on determining the opening balance of accumulated depreciation on the implementation of GAMAP.

In order to calculate backlog depreciation, information will be required on the historical cost and acquisition date of all property, plant and equipment. This information may not be easy to determine and certain procedures and assumptions will need to be made as illustrated in this chapter.

Global amounts

Data is likely to be incomplete as a result of the two demarcation processes. Some Fixed Assets Registers may show global amounts, such as office furniture, rather than a detailed listing of the individual assets in each global amount.

Municipalities have a number of options to consider when dealing with this challenge. These are set out below.

- Firstly, the municipality can perform an asset count and allocate costs on a pro rata basis, taking into account the age and physical appearance of the assets that are assumed to be included in the global amounts. This will be a time-consuming exercise and it is unlikely to be completed before the planned implementation date. There is also a cost implication to this option and a risk of audit query, owing to the subjective nature of determining asset values.
- An alternative option is to write off these assets on the basis that they are likely to have exceeded their useful lives from a depreciation perspective. It is therefore unlikely that the balance sheet will be materially misstated. Whilst this option is likely to result in audit queries, it will be easy to implement from a timing perspective and will not have significant cost implications.
- A third option is to revalue all assets and then use the revaluation amount to record asset values at fair value. This will be a once-off revaluation for implementation purposes. The revaluation reserve that will be created will need to be allocated to specific assets and the original global amounts written off.

Municipalities should select the option that is most appropriate to their individual circumstances, cost-effective and pragmatic. An approach should be documented, discussed with the Office of the Auditor-General and submitted to Council for approval.

Incomplete or missing acquisition dates

Acquisition dates are crucial to standards implementation. Acquisition dates are paramount to the calculation of accumulated depreciation to date and incomplete or missing dates will have the effect of hampering the implementation of the standards.

Municipalities have a number of options to consider when the acquisition dates of items of property, plant or equipment are not known. These are set out below.

- Where acquisition dates are not known, a process to check old accounting records, such as internal advances registers, external loan registers and approved budgets, to ascertain whether such information is available should be investigated. Whilst this option will provide accurate information for determining acquisition dates, it could take considerable time. There is also likely to be a cost implication owing to a lack of capacity.
- A second option is to physically identify the items of property, plant and equipment in question and determine a likely acquisition date based on visual evaluation. This approach may be criticised from an audit perspective and will be time-consuming and costly owing to the need to contract extra staff. It may also be difficult to identify specific items of property, plant and equipment to undertake a visual evaluation.
- The third option is to assume that the municipality has owned these assets for periods that are longer than their useful lives for depreciation purposes. This will certainly result in audit queries, but will be easily to implement and will have no cost implications from a capacity perspective.

Municipalities should select the option that is most appropriate to their individual circumstances, cost-effective and pragmatic. An approach should be documented, discussed with the Office of the Auditor-General and submitted to Council for approval.

Vague asset descriptions

Municipalities may discover that descriptions of individual assets in the Fixed Assets Register are vague. The implication of these vague descriptions is that it will be difficult to apply the prescribed depreciation rates included in GAMAP 17 to such asset descriptions.

A detailed review of the asset register should be done and vague descriptions investigated. If further information is not available, then such items should be written off. These write-offs should be done prior to implementation so that there are no operating losses in the Statement of Financial Performance.

Municipalities should maintain proper information on such write-offs, obtain council approval and provide the Office of the Auditor-General with suitable evidence.

Incomplete financing sources

Municipalities must record the financing sources of all property, plant and equipment to facilitate the implementation process. The reason is that Loans Redeemed and Other Capital Receipts must be unbundled on the date of implementation. Furthermore, account balances such as internal loans must also be reversed.

Municipalities that are unable easily to determine the original source of financing have a number of options to consider when dealing with the above-mentioned challenges:

- Firstly, a process to check old accounting records to ascertain whether such information is available can be followed. Whilst this option will provide accurate information, it will

take considerable time. There is also likely to be a cost implication owing to capacity constraints. However, it should be noted that municipalities were required to include a reconciliation of the financing of property, plant and equipment in their financial statements up to 30 June 1996, so in certain instances it will not be too difficult to obtain this information. It should also be noted that information on external loan and government grant funded items of property, plant and equipment may be relatively easy to obtain in relation to other financing sources, as these are typically project-linked and in the case of government grants the majority of transactions will have occurred only in recent years.

- An alternative option is to allocate assets to the different financing sources that constitute Loans Redeemed and Other Capital Receipts by using the description of the asset to determine a likely financing source based on general practice in the past. For example, office furniture is likely to have been funded by Revenue Contributions, whereas major infrastructure is likely to have been funded from External Loans. This approach may be criticised from an audit perspective, will be time-consuming and costly owing to the need to contract extra staff and limited as it will be difficult to be consistent in the process since the size of the former disestablished municipalities that are now part of a municipality will be an important determinant of what revenue sources would have been used.

Municipalities should select the option that is most appropriate to their individual circumstances, cost-effective and pragmatic. An approach should be documented, discussed with the Office of the Auditor-General and submitted to Council for approval.

Long-life assets

Most municipal Fixed Assets Registers in respect of long-life assets are inadequate. This is due to historical factors and the use of the fund accounting system. Property, plant and equipment that is classified as “Infrastructure Assets” will typically be a long-life assets. It is likely that such assets will need to be revalued on a regular basis when accounting standards are updated, as depreciation is not an appropriate measure of the consumption of such assets.

It will, however, always be necessary to depreciate such assets. What this means is that such assets must be separately identifiable in the Fixed Assets Register. For example, all roads should be specifically identified and listed in the Fixed Asset Register. Unfortunately, only global amounts are currently recorded in the Fixed Assets Register. Acquisition dates and historical cost prices for each infrastructure asset will need to be recorded to enable the calculation of depreciation.

It may not be possible to undertake this when standards are implemented. Instead, an average cost and age will need to be applied to infrastructure assets based on historical budget and financial statement information where available.

Unfortunately this will result in audit qualification until this information is provided. However, it will be paramount to prepare a process map to obtain this information over a number of years. Internationally, it has taken municipalities up to eight years to prepare this detailed asset information. The National Treasury encourages municipalities to address this matter as soon as possible, for it does take cognisance of the challenges involved. Realistic timeframes must be set to obtain this information.

Most municipalities will not be able to list all infrastructure assets in the Fixed Assets Register owing to the vast extent of the infrastructure. For example, listing every single road and set of traffic lights will make the Fixed Asset Register unusable. Instead, consideration should be

given to dividing the municipal area up into areas, each of which will have a master plan detailing the cost and age of infrastructure. These master plans will be summarised into the Fixed Assets Register.

Typically the engineering and operational departments of the municipality will have technical plans detailing the infrastructure, as these will be used for maintenance purposes. The challenge is to aggregate such plans as a holistic representation of all items of infrastructure in a specific area.

Once “infrastructure areas” have been demarcated, the process of allocating historical costs to infrastructure can commence. Initially this can be done using recent budgets and financial statements. However, owing to the lack of detailed information, assumptions will have to be made with regard to older assets. Again, by using the detailed plans maintained by the engineering and operational departments, subjective estimates of the age of these assets can be made.

The global historical cost in the Fixed Asset Register will then need to be allocated to infrastructure. The easiest way to do this will be to allocate costs where accurate information is available (recent budgets and financial statements) and thereafter to allocate historical costs on a pro rata basis to infrastructure using an averaging method. An example of an averaging method is where road costs are determined on a per kilometre basis (total historical cost of roads divided by the total length of roads). Each road is then measured and the calculated cost per kilometre is applied.

Adjustments to accumulated depreciation determined at the implementation date can then be made, taking into account the age of the assets based on the subjective assessment referred to above.

Project plans should be prepared and responsibility assigned to officials. The importance of such a plan is that whilst the Auditor-General may have to qualify the financial statements of the municipality because infrastructure assets are not separately listed and identified, cognisance will have to be taken of this plan.

Conclusion

The National Treasury expects municipalities to carefully consider an approach to preparing their Fixed Assets Registers that is appropriate to their specific circumstances. It is of the utmost importance to ensure that an opening depreciable balance of property, plant and equipment is determined that will not distort the operating surplus through inaccurate future annual depreciation charges.

If the information in the Fixed Assets Register is incomplete or inadequate to determine fair value, then a revaluation approach (referred to as method 2 above) must be used. This could be costly, but will result in a more realistic and accurate Fixed Assets Register on which to base the annual depreciation charge. A revaluation reserve will need to be created on implementation and retained until the relevant property, plant and equipment is disposed of.

Chapter 4: Unbundling Loans Redeemed and Other Capital Receipts

Unbundling of 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 also 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
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 (see Note 1 below)	Determine backlog depreciation	Allocate balance of funding to accumulated depreciation	Balance to either FDR if externally funded or unappropriated surplus if internally funded

Note 1: 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.

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 assets.

Example of unbundling Loans Redeemed and Other Capital Receipts

The unbundling of Loans Redeemed and Other Capital Receipts process can be explained using the following example:

Assume that a municipality has reconciled its Loans Redeemed and Other Capital Receipts to the Fixed Assets Register. The total of Loans Redeemed and Other Capital Receipts is listed in Table 1 below. Backlog depreciation has been calculated on the items of property, plant and equipment and appears in Table 2 below. The backlog depreciation is funded from the Loans Redeemed and Other Capital Receipts and the residual transferred to either Future Depreciation Reserves or the unappropriated surplus.

Table 1: Summary of Loans Redeemed and Other Capital Receipts

External loans redeemed	50 000
Contributions from revenue	10 000
Government grants	250 000
Public contributions	25 000

Table 2: Summary of Backlog Depreciation

External loans redeemed	45 000
Contributions from revenue	6 000
Government grants	40 000
Public contributions	18 000

The following journal entries will be processed against the various Loans Redeemed and Other Capital Receipts accounts:

External Loans Redeemed	Debit	Credit
Loans redeemed (internal)	50 000	
Accumulated depreciation		45 000
Balance – unappropriated surplus		5 000

Contributions from Revenue	*Debit*	*Credit*
Contributions from revenue	10 000	
Accumulated depreciation		6 000
Balance – unappropriated surplus		4 000

Government Grants	*Debit*	*Credit*
Government grants	250 000	
Accumulated depreciation		40 000
Balance – Future Depreciation Reserve		210 000

Public Contributions	*Debit*	*Credit*
Public contributions	25 000	
Accumulated depreciation		18 000
Balance – Future Depreciation Reserve		7 000

Once these journal entries have been processed –

- Loans Redeemed and Other Capital Receipts will have a zero balance;
- backlog depreciation will have been created; and
- the various Future Depreciation Reserves required in terms of the new capital accounting model will have been created.

The "old" financing sources will be renamed to now comply with the financing sources in the new capital accounting model. For example, "External Loans Redeemed" will convert to "EFF" and "Contributions from Revenue" to "Surplus Cash" financing.

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.

Chapter 5: Process to establish the External Financing Fund and Asset Financing Reserve

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 AFR. The AFR is equivalent to a savings account and only has one asset, namely a dedicated bank or investment account.

Municipalities must first establish an AFR on the implementation of accounting standards. Once a draft 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 AFR. Where there is insufficient cash or investments, then the balance of the AFR is written down to the balance of cash or investments.

The AFR can be increased by transferring amounts from unappropriated surpluses to the 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 AFR.

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

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

The following process map should be used to establish the AFR where there is not a Consolidated Loans Fund (CLF). There is a separate section in this chapter on unbundling the 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 AFR. Reverse the “unfunded” balance to the unappropriated surplus.

This process can be illustrated using the following example:

Assume that a municipality has a Capital Development Fund and a Land Trust Fund with balances as shown below. These statutory funds have used part of their funds to make internal loans to borrowing services, which is also shown below.

CAPITAL DEVELOPMENT FUND					
	External investments	250	4	Accumulated Fund	1 000
	Internal investments	750			
	TOTAL	1 000		TOTAL	1 000

LAND TRUST FUND					
	External investments	100		Accumulated Fund	500
	Internal investments	400			
	TOTAL	500		TOTAL	500

BORROWING SERVICES: INTERNAL LOANS					
				Loan from the Capital Development Fund	750
				Loan from the Land Trust Fund	400

To establish the AFR, the Land Trust Fund must be aggregated with the Capital Development Fund. This is an aggregation exercise. After consolidation, a draft AFR will be created with the following balances:

DRAFT AFR					
	External investments	350		Accumulated Fund	1 500
	Internal investments	1 150			
	TOTAL	1 500		TOTAL	1 500

In terms of the suggested process map an amount equivalent to the value of internal loans outstanding (R1 150) must be transferred from the Accumulated Fund to a Future Depreciation Reserve. In addition, the internal investments must be written off against the internal loans in the borrowing services. When these entries have been processed, the following balances will appear in the accounting records:

AFR					
	External investments	350		Accumulated Fund	350
	Internal investments	0			
	TOTAL	350		TOTAL	350

FUTURE DEPRECIATION RESERVE: AFR					
				Transfer from AFR: Accumulated Fund	1 150
				TOTAL	1 150

There will no longer be a Borrowing Services: Internal Loan account, as these balances have been written off against the internal investments that were included in the draft AFR.

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 that has been utilised to finance property, plant and equipment and what is unspent. The various EFF accounts, as explained in chapter 2, can then be established and maintained as explained in that chapter.

Unbundling the CLF to establish the EFF and AFR

The steps to unbundle the CLF can best be illustrated by using the following example:

Assume that a municipality has a Capital Development Fund and a Land Trust Fund with balances as shown below. These statutory funds have invested their accumulated funds in the CLF. In addition, external loans of R500 have also been allocated to the Consolidated Loans Fund. Advances of R1 100 have been made to borrowing services. These borrowing services have recognised this advance, which is also shown below.

CAPITAL DEVELOPMENT FUND			
Investment in the CLF	525	Accumulated Fund	525
TOTAL	525	TOTAL	525

LAND TRUST FUND			
Investment in the CLF	350	Accumulated Fund	350
TOTAL	350	TOTAL	350

CONSOLIDATED LOANS FUND			
External investments	275	External Loans	500
Internal advances to Rate & General Services	1 100	Investment ex Capital Development Fund	525
		Investment ex Land Trust Fund	350
TOTAL	1 375	TOTAL	1 375

BORROWING SERVICES: INTERNAL LOANS			
		Internal advances ex Consolidated Loans Fund	1 100
TOTAL		TOTAL	1 100

The process to unbundle these accounts is as follows:

- **Step One:** Split internal advances into those funded from external loans and those funded from the Capital Development Fund and Land Trust Fund investments in the CLF. This is a judgmental exercise.

Total internal advances	1 100
Allocated to external loans	500
Allocated to CDF	450
Allocated to Land Trust	150

- **Step Two:** Split external investments held in the CLF between external loans and the CDF and Land Trust investments in the CLF. This is determined as follows:

Components	Total	Allocated to internal advances (per Step One above)	Allocated to external investments (balance)
External loans	500	500	0
Investment ex CDF	525	450	75
Investment ex LTF	350	150	200
TOTAL	1 375	1 100	275

- **Step Three:** Unbundle internal transactions and balances from the CLF.

CONSOLIDATED LOANS FUND			
External investments	275	External loans	500
Internal advances	1 100	Investment ex CDF	525
		Investment ex LTF	350
TOTAL	1 375	TOTAL	1 375
Unbundled as follows:			
Investment ex CDF (J/E1)	525	External investments (J/E1)	75
Investment ex LTF (J/E2)	350	Internal advances (J/E1)	450
		External Investment (J/E2)	200
		Internal Advances (J/E2)	150

Journal Entry 1: Unbundling CDF

	Debit	*Credit*
Debit: Investment ex CDF	525	
Credit: External investments		75
Internal advances		450

Journal Entry 2: Unbundling Land Trust Fund

	Debit	*Credit*
Debit: Investment ex LTF	350	
Credit: External investments		200
Internal advances		150

After processing these two journal entries, the CLF will appear as follows:

CONSOLIDATED LOANS FUND			
External investments	0	External loans	500
Internal advances	500		
TOTAL	500	TOTAL	500

- **Step Four:** Change the adjusted CLF into the EFF.
- **Step Five:** Process journal entries 1 and 2 in the Capital Development Fund and Land Trust Fund accordingly. Remember to switch the debits and credits.

CAPITAL DEVELOPMENT FUND			
Investment in the CLF	525	Contributions from income	450
		Interest earned	75
External investments (J/E1)	75	Investment in the CLF (J/E1)	525
Internal advances (J/E1)	450		
TOTAL	525	TOTAL	525

LAND TRUST FUND			
Investment in the CLF	350	Accumulations	300
		Interest earned	50
TOTAL	350	TOTAL	350
External investments (J/E2)	200	Investment in the CLF (J/E2)	350
Internal advances (J/E2)	150		
TOTAL	350	TOTAL	350

- **Step Six:** Consolidate the CDF and Land Trust Fund into the AFR.

AFR			
External investments	275	Accumulations (525 + 350)	875
Internal advances	600		
TOTAL	875	TOTAL	875

In terms of the new capital accounting model, when AFR monies are used to finance capital a transfer is made from the AFR to a Future Depreciation Reserve. This entry must now be processed.

- **Step Seven:** Transfer amount of AFF used to finance capital.

	Debit	*Credit*
Debit: AFF accumulations	600	
Credit: AFF: Future Depreciation Reserve		600

- **Step Eight:** Reverse internal advances (as AFR no has internal advances).

	Debit	*Credit*
Debit: Internal loans – R&T	600	
Credit: AFF Internal Advances		600

After performing steps 7 and 8, the following balances will be in the books:

EFF (see Step 4)			
Internal advances	500	External loans	500

AFR			
External investments	275	Accumulations	875
Internal advances	600	Step 7 – journal entry	(600)
Step 8 – journal entry	600		
TOTAL	275	TOTAL	275

FUTURE DEPRECIATION RESERVE (AFR)			
		Step 7 – journal entry	600

BORROWING SERVICE: INTERNAL LOANS (NOW ADVANCE EX EFF)			
Step 8 – journal entry	600	Advances	1 100
Balance	500		525
TOTAL	1 375	TOTAL	1 375
		Balance b/f	500

Conclusion

The establishment of the AFR and EFF, particularly where there is a CLF, is a technically difficult exercise. It is important that the new capital accounting model is fully understood, so that the objectives of the unbundling process can be conceptualised.

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

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

Chapter 6: Process to reclassify provisions and reserves

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

Although there are similar provisions and reserves in a number of municipalities, their nature may differ. 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 on 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.
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 not obligations, the amounts should be transferred to the 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.

Example of provision or reserve	Principles to be applied	Treatment on implementation
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 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 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.

Conclusion

The concept of rationalising excessive provisions and reserves from an annual financial statement perspective is to promote consistency and to assist users understand 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.

Chapter 7: Housing and township developments

Overview of old and new scheme housing

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.

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 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.

Chapter 8: Other standards implementation issues

Trust funds

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.

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 explained in chapter 2.
- 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.

Bad debt provisions

A user of municipal annual financial statements will have an expectation that municipalities will only show debtors' balances on the face of the Statement of Financial Position that are likely to be received in the form of cash receipts. Where there is a probability that debtors will not pay their municipal accounts, an accurate provision for bad debts must be created on implementation of the new accounting standards.

This provision must be realistic based on past payment trends, debtors' past payment trends and the likelihood that the total balance outstanding at the implementation date will be paid. Where it is less probable that consumers will settle their outstanding accounts, provision should be made.

Municipalities are encouraged to use any surpluses arising from the implementation of accounting standards to increase their bad debt provision. Specifically, where the AFR's accumulated fund is adjusted downwards to cash or investment balances attributable to the AFR, the reversal of the AFR should be transferred to the bad debt provision. The reason is that it is likely that the cash or investments of the former statutory funds that have been amalgamated to create the AFR have been used to finance the increase in debtors' balances.

Consolidation of municipal entities

The Municipal Finance Management Act requires municipalities to prepare consolidated annual financial statements. GAMAP 6 provides guidance on how consolidated financial statements must be prepared. On the date of implementation of the standards, a consolidated Statement of Financial Position must be prepared on 1 July, which is the opening balance in the year of accounting standards implementation.

Municipal entities will need to prepare annual financial statements in terms of the legal framework in which they were established and in accordance with the new standards to facilitate consolidation into the controlling municipality's consolidated annual financial statements. On the implementation of the standards, procedures must be developed to require municipal entities to prepare accounting standards compliant financial information to be used for consolidation purposes.

Internal interest and loan redemption capital charges

In terms of the accounting standards, there will no longer be internal interest charged on internal loans or advances from the AFR. The reason is that the concept of internal loans and advances has been discontinued. There will also no longer be internal or external loan redemption capital charges, as loan repayments no longer meet the definition of an expense.

Instead of loan redemption capital charges, all property, plant and equipment, with the exception of land and heritage assets, will be depreciated. It is unlikely that the introduction of a depreciation expense will result in higher capital charges, as internal interest and loan redemption expenses will no longer be included in the Statement of Financial Performance.

Chapter 9: Summary of the implications of the standards post-implementation

Post-implementation matters to consider

The purpose of this chapter is to summarise the post-implementation impact of the standards, so that municipalities are able to amend their accounting procedures and accounting records once the standards have been implemented. In order to facilitate this process, brief comments have been made on each accounting standard as at the date of these guidelines.

Municipalities must read and study these standards to ensure that there is compliance with each of the requirements of these statements. This chapter merely provides a general high-level review and does not relieve municipal finance officials of the need continually to study the accounting standards approved by the ASB.

The comments on the GRAP and GAMAP standards have been given in the order set out in Chapter 1.

GRAP 1: Presentation of financial statements

The National Treasury has prepared specimen financial statements illustrating the requirements of this accounting standard. These specimen financial statements should be used to understand this accounting standard.

GRAP 3: Accounting policies, changes in accounting estimates and errors

Municipalities must prepare accounting policies on the date of implementation, so that account balances and transactions are in accordance with the accounting policies described in the annual financial statements. Again, reference should be made to the specimen financial statements to gain an understanding of the accounting policies that could be developed on the implementation of the standards. It is important to note that each standard provides guidance on the accounting treatment of transactions and account balances and the prescribed treatments will constitute the accounting policy of the municipality.

Accounting policies should be approved by the municipal council and be applied consistently. Where subsequent changes to accounting policies are made, there must be compliance with the requirements of this accounting standard.

A post-standard implementation implication of GRAP 3 is that the previous system of processing prior-year adjustments to appropriation accounts is no longer permitted. If the previous financial statements were misstated and the amount is material, then the comparative amounts must be restated and detailed information disclosed in accordance with this accounting standard. If the misstatement in prior-year financial statements was immaterial, then the transaction is recorded in the current year.

GAMAP 19: Provisions, contingent liabilities and contingent assets

There are no significant implications arising from this accounting standard. Obviously, where there are present obligations, these need to be recorded as such in the accounting records.

It should be noted that this standard excludes present obligations emanating from retirement benefits. There is at present no standard that mandates that post-retirement and medical benefit

liabilities be included in municipal financial statements. Municipalities may, however, on a voluntary basis, use SA GAAP AC116 for guidance on retirement benefits if they decide to make provision for these obligations.

GAMAP 12: Inventories

The only post-implementation implication of this accounting standard is that municipalities need to ensure that all inventories, as defined in the accounting standard, are recorded as such. Historically, municipalities may have excluded unsold water, nursery plants, clinic medicines and fuel from inventory. On the implementation of this standard, municipalities will need to ensure that all inventories that are material are recorded as such.

GAMAP 7: Accounting for investments in associates

This accounting statement will apply to those municipalities that do not have a controlling interest in municipal entities but nevertheless exercise significant interest. These interests in municipal entities will be included in consolidated financial statements or, if consolidated financial statements are not prepared, in the municipality's own financial statements. Chapter 8 sets out the implementation implications in more detail.

GAMAP 6: Consolidated financial statements and accounting for controlled entities

This accounting statement will have accounting standards implementation ramifications. Chapter 8 sets out these implications in more detail.

GAMAP 9: Revenue

There are major ramifications arising from this statement. Conditional capital grants are recorded as revenue as described in Chapter 2, which explains the new capital accounting model.

In addition, no revenue is recorded in the Statement of Financial Position. All revenue must be included in the Statement of Financial Performance. For example, it has been municipal accounting practice to include revenue from external recoverable works, such as road reinstatements, as a clearing account or suspense account in the Statement of Financial Position. This is no longer permissible and such revenue sources must be included in the Statement of Financial Performance.

A further change is that interest received on external investments can no longer be fund accounted. All interest received must be recorded as revenue and included in the Statement of Financial Performance. In respect of district and metropolitan municipalities, there is now a standard prescribed accounting treatment for RSC levies. In certain instances, this will involve a change in accounting policy, as there are numerous accounting policies that will no longer comply with GAMAP 9.

GAMAP 4: The effects of changes in foreign exchange rates

This statement will only apply to municipalities that import goods or services. It is not likely to have a significant impact on municipal financial reporting.

GRAP 2: Cash flow statements

Cash flow statements are prepared only for annual financial statement reporting purposes. However, it is important to note that municipalities are encouraged to prepare cash flow statements on the direct reporting method. This requires municipalities to determine operating cash flows, both receipts and payments, to be in a position to prepare the cash flow statement.

Wherever possible, municipalities will need to review the structure of their cash books to enable this information to be easily obtained at year-end for the purposes of preparing their annual financial statements.

GAMAP 8: Financial reporting of interests in joint ventures

This accounting statement will have accounting standards implementation ramifications. Chapter 8 sets out these implications in more detail.

GAMAP 17: Property, plant and equipment

This accounting statement has major ramifications for municipalities. In addition to the financing of property, plant and equipment as described in chapter 2, there is also a need to prepare a Fixed Assets Register on the date of implementation and continually to update it thereafter. Chapter 3 provides guidance on updating the Fixed Assets Register.

A further implication of the standards is that there will now be gains and losses on the disposal of property, plant and equipment. Where the proceeds on the disposal of property, plant and equipment are less than the carrying value, a loss will be incurred. However, where the proceeds are greater than the carrying value of property, plant and equipment disposed of, a gain will be realised. Both gains and losses on the disposal of property, plant and equipment will be included in the Statement of Financial Performance.

Chapter 10: Summary of the standards implementation process

This guideline has summarised the accounting standards implementation process. The starting point of the implementation process is to update the Fixed Assets Register and balance the total of the Fixed Assets Register to Loans Redeemed and Other Capital Receipts, taking into account external and internal loans outstanding. This information is fundamental to the implementation of the standards.

Once this has been done, the calculation and unbundling of Loans Redeemed and Other Capital Receipts can be undertaken. The ease with which this task can be performed will depend on the status of the accounting records and the information that is included in the Fixed Asset Register in particular.

The last key task is to establish the AFR and EFF from the existing statutory funds, provisions and reserves. These tasks constitute the majority of the work that is involved in implementing the accounting standards.

The remaining implementation tasks revolve around changes to existing accounting and budgeting processes. Municipalities will need to consider their operations carefully to identify transactions and account balances that may be affected by both existing accounting standards and the standards that will be approved by the ASB in future years.

It is important that accounting standards implementation is properly planned and managed so that municipalities can convert to GRAP when required. These guidelines should assist in this regard.

Compliance with the accounting standards

These implementation guidelines will assist municipalities convert from a fund accounting system to the new accounting standards. In preparing these guidelines, compliance with existing accounting standards has been emphasised. The information in this guide does not contravene any accounting standard.

Municipalities must ensure compliance with accounting standards at all times. These guidelines will assist municipalities in this regard.

Early implementation of standards

Chapter 1 sets out the implementation dates of the standards according to municipalities' different levels of capacity. Notwithstanding these dates, municipalities are encouraged to implement the accounting standards at an earlier date, subject to financial and organisational skills and capacity.