MUNICIPAL FINANCE MANAGEMENT ACT (56 of 2003)

Guidelines on implementation of approved standards of generally recognised accounting practice

Local Government

National Treasury
June 2005

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CHAPTER 1: BACKGROUND AND INTRODUCTION

Background and status of accounting standards[1]

The Constitution requires National Treasury to introduce Generally Recognised Accounting Practice (GRAP) for all spheres of government. The Accounting Standards Board (ASB) has been established to set standards of GRAP (also referred to as accounting standards). Once approved by its Board, the ASB recommends to the Minister of Finance effective dates of implementation of these accounting standards. It is the Minister's prerogative to determine the implementation dates. A standard of GRAP applies from a date determined in a regulation issued by the Minister of Finance, after consultation with the ASB. The Board has approved a number of accounting standards and these have been submitted to the Minister for gazetting of the implementation date. The ASB has also approved a number of Generally Accepted Municipal Accounting Practice (GAMAP) standards as interim GRAP applicable only to municipalities and municipal entities.

Over time, the local government accounting standards that have been approved by the ASB will be replaced by the national GRAP standards. Although old local government standards have been in the public domain since 1998, the ASB has updated these standards to take into account developments that have occurred in accounting since 1998. The purpose of updating the old standards is to ensure that there is a core set of accounting standards applicable to all spheres of government.

The ASB, through its various workgroups, is responsible for developing and issuing accounting standards. The National Treasury is responsible for developing implementation guidelines and issuing Specimen Annual Financial Statements in accordance with the accounting standards issued by the ASB. The Auditor-General is responsible for auditing financial statements in line with these accounting standards and the formats.

The conversion from the current fund accounting framework to new accounting 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.

This guideline also explains the accounting treatment that has been developed by 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 deal specifically with property, plant and equipment, are also illustrated in the municipal specimen annual financial statements that have been issued by National Treasury and accompany this guide.

This guideline is not intended as an explanatory guide on understanding or interpreting the new accounting standards. The guideline assumes that readers and those responsible for using this guideline have studied and understood the relevant accounting standards prior to undertaking the implementation process. The key objective and purpose of this guideline is to assist in the implementation of the new accounting standards.

[1] This guide must be read in conjunction with MFMA Circular 18 on "Implementation of New Accounting Standards and Format of Annual Financial Statements" available on National Treasury's website.

Implementation dates[2]

In terms of Government Gazette Number 26511 dated 1 July 2004, the date of implementation of new accounting standards in local government varies according to the capacity classification of municipalities listed in the Gazette. High capacity municipalities must implement the new accounting standards with effect from 1 July 2005 in order to prepare new standards compliant annual financial statements for the financial year that ends 30 June 2006. For medium capacity municipalities the corresponding dates are 1 July 2006 to 30 June 2007 and for low capacity municipalities the dates are 1 July 2007 and 30 June 2008. Municipalities are encouraged to implement the new accounting standards as soon as possible regardless of their capacity assessment, provided they have the skills, systems and policies to do that.

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 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 a municipality or municipal entity as indicated in the table below must be made by accounting officer of the municipality or municipal entity and must be made in writing.
- The accounting officer 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.

[2] See section under "Implementation by capacity" in MFMA Circular No. 18.

Standards to be taken into account on implementation[3]

The following table summarises the status of accounting standards as at the date of these implementation guidelines. The table lists the new local government accounting standards that replaced the old standards, as well as the new national standards of GRAP.

Old standard reference	Title	New standard reference
GAMAP 000	Framework for the Preparation and Presentation of Financial Statements	ASB issued framework.
	Preface to Standards of Generally Recognised Accounting Practice	Issued by the ASB
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 standard	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 standard	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

[3] Refer to section under “GAMAP and GRAP standards” in MFMA Circular 18 for applicable standards at this stage.

Accounting standards implementation principles

The National Treasury is aware that the implementation of the standards will be a time-consuming and costly exercise. Much is dependent on the status of accounting records that have been maintained historically. The two demarcation processes, which have resulted in various amalgamations and the bringing together of former local government entities governed in terms of different legislation, will add 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 which will not result in the spending of considerable funds. This, however, requires to be balanced with the need 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 prepares and produces accurate financial statements taking into account its own individual and specific circumstances.

Overview of the accounting 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 statement of financial position (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.
The following tables have been prepared to illustrate 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.

In respect of the Statement of Financial Performance, the major changes arising from the implementation of accounting standards are as follows:

- All external interest earned will be included as revenue in the Statement of Financial Performance. No external interest earned will be credited to a statutory fund, reserve or provision.
- Government grants, public contributions and donations will be recognised as revenue to the extent that there has been compliance with the conditions associated with such government grant, public contribution or donation.
- Internal interest and internal redemption charges are no longer recognised in the annual financial statements.
- External loan redemptions are no longer recognised as an expense.
- Depreciation is now recognised as an expense.
- Contributions to statutory funds and reserves, including the self-insurance reserve, are no longer included as expenses. Instead, transfers are made from the accumulated surplus/deficit to such statutory funds and reserves.
- Gains and losses on the disposal of property, plant and equipment are recognised as revenue or as expenses.

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 standard compliant Statement 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 CRR Transfer to CRR Transfer to CRR Transfer to CRR Transfer to CRR Retain	The various Statutory Funds are initially amalgamated and then a Capital Replacement Reserve 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 Chapter 5 on establishing the CRR. 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 Accumulated Surplus/Deficit	Reverse Transfer to liabilities or include in accumulated surplus Reverse Transfer to Liabilities Retain Unchanged	The general rule is that a CRR must be created as set out in Chapters 2 and 5. The CRR is established from existing Statutory Funds, excluding the Housing Development Fund, as illustrated above. In terms of the requirements of chapter 2 dealing with property, plant and equipment, a Capitalisation Reserve or a Government Grant Reserve or a Public Contributions and Donations Reserve 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.	Capital Replacement Reserve (CRR) Capitalisation Reserve Government Grant Reserve Public Contributions and Donations Reserve Self-Insurance Reserve Accumulated Surplus/Deficit
Trust Funds			*Separate financial statements.*
Unspent Government Grants	Transfer to Liabilities	Traditionally the terminology "Monies held in Trust", with specific reference to government grants, was disclosed as a	

Former fund accounting Statement of Financial Position	Implementation process	Description of implementation process and reference to these guidelines	New standard compliant Statement of Financial Position
Trusts where Municipality is Trustee	Separate financial statements; Include in consolidated financial statements if Trust Fund is controlled by Municipality	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. Trust Funds are separate legal entities where the Municipality is trustee. As separate legal entities, separate financial statements should be prepared for each Trust Fund.	Separate financial statements (where Municipality is trustee in terms of a Trust Deed). Trust Funds included in consolidated financial statements when municipality controls the Trust Fund

Former fund accounting Statement of Financial Position	**Implementation process**	**Description of implementation process and reference to these guidelines**	**New standard compliant 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 no 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. Staff leave will be disclosed under current liabilities.	Trade creditors Payments received in advance Bank overdrafts Short-term portion of long-term debt Unspent conditional grants and receipts Staff leave disclosed as creditors Consumer deposits
Property, Plant and Equipment (PPE)			Property, Plant and Equipment (PPE)
PPE at cost Less Loans Redeemed and other Capital Receipts	Unchanged	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	PPE at cost Less Accumulated Depreciation

▪ Loans redeemed Contributions from revenue Government grants Public contributions	Unbundled Unbundled Unbundled Unbundled	Receipts must be reversed. Loans Redeemed and Other Capital Receipts must initially be used to finance backlog depreciation and establish the Capitalisation Reserve, Government Grants Reserve, and the Public Contributions and Donations Reserve referred to in Chapter 2 and the residual balance transferred to either the CRR or Accumulated surplus/deficit. The unbundling process is explained in Chapter 4.	

Former fund accounting Statement of Financial Position	**Implementation process**	**Description of implementation process and reference to these guidelines**	**New standard compliant 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 inventory. 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
Current Assets			Current Assets
Consumer debtors Inventory Current portion of long-term debtors Investments Cash and bank balances	Unchanged Unchanged Unchanged Unchanged Unchanged	There are no changes affecting current assets emanating from the implementation of GAMAP. 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 Investments Cash and bank balances

CHAPTER 2: ACCOUNTING FOR PROPERTY, PLANT AND EQUIPMENT

Principles of accounting for property, plant and equipment

The accounting for property, plant and equipment is applied if the following sources of financing are used to acquire items of property, plant and equipment: -

- Surplus cash;
- External loans;
- Government grants and public contributions/donations; and
- Capital Replacement Reserve.

The key principles of each of these financing methods are explained in this Chapter.

Examples have also been developed to illustrate each of these financing methods. The principles of accounting for property, plant and equipment have been developed taking the following into account:

- The new budget reforms;
- The Municipal Finance Management Act;
- Community equity; and
- 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 their 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 when the relevant item of property, plant and equipment is brought into use through the establishment of the Government Grants Reserve or the Public Contributions and Donations Reserve. There is also a need to comply with GAMAP 9, which requires that the value of government grant funded property, plant and equipment must 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 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 recognised as revenue is appropriated to the Government Grants Reserve through the Statement of Changes in Net Assets. Thereafter, the Government Grants Reserve is transferred to the accumulated surplus annually in accordance with the depreciation charge relating to such asset, again using the Statement of Changes in Net Assets.

If the item of property, plant and equipment is disposed prior to being fully depreciated, the balance in the Government Grants Reserve/ Public Contributions and Donations Reserve, which will equal the carrying value of the item of property, plant and equipment disposed, will be transferred to the accumulated surplus through the Statement of Changes in Net Assets.

The principle of using the Capital Replacement 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. The Capital Replacement Reserve is a mechanism to be used in this regard. In addition, on implementation of new standards, most municipalities will have existing funds. As explained later in these guidelines, these existing funds will be consolidated into the Capital Replacement Reserve.

To prevent double taxation by having to fund annual depreciation charges, when the Capital Replacement Reserve is used to finance the acquisition of property, plant and equipment, a once-off transfer equal to the amount used to finance the item of property, plant and equipment is made from the Reserve to Accumulated Surplus/Deficit to accommodate future annual depreciation charges on these assets.

The principles of the accounting for property plant and equipment are not significantly different to that of what was originally called the capital accounting model as part of "old local government standards". There has been significant capacitation on the old capital accounting model and National Treasury has published an overview of the model.

Example of financing from surplus cash

Assume the following example:

> A Municipality has internally generated positive cash flows and decides to acquire an item of property, plant and equipment costing R1 000. The item of property, plant and equipment has a useful life of 5 years. The item of property, plant and equipment is acquired on 1 July 2004.

The following accounting entries will be processed in the accounting records in the year ending 30 June 2005:

CASH					
0	Available cash	1 000	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

0. This is the cash on hand on 1 July 2004.
1. This is the amount paid for the purchase of the item of property, plant and equipment.
2. This is the annual depreciation (R1000 ÷ 5).

This transaction will be disclosed as follows in the annual financial statements for the year ending 30 June 2005.

EXTRACT FROM STATEMENT OF FINANCIAL PERFORMANCE FOR THE YEAR ENDED 30 JUNE 2005	
EXPENDITURE	**2005**
Depreciation	200

EXTRACT FROM STATEMENT OF FINANCIAL POSITION AT 30 JUNE 2005		
	Note	**2005**
Non-current assets		
Property, plant and equipment	1	800

Note: 1. Property, Plant and Equipment as at 30 June 2005

DESCRIPTION	COST	ACCUMULATED DEPRECIATION	CARRYING VALUE
Item of property, plant and equipment	1 000	200	800
Total	**1 000**	**200**	**800**

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 and equipment. The loan is repayable after 5 years. The item of property, plant and equipment has a useful life of 5 years. The item of property, plant and equipment is acquired on 1 July 2004.

The following accounting entries will be processed in the accounting records in the year ending 30 June 2005:

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 and 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 and equipment.
4. The service that will use the external loan to acquire an item of property, plant and 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 and 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 and 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.

This transaction will be disclosed as follows in the annual financial statements for the year ending 30 June 2005.

EXTRACT FROM STATEMENT OF FINANCIAL PERFORMANCE FOR THE YEAR ENDED 30 JUNE 2005	
EXPENDITURE	
Depreciation	200

EXTRACT FROM STATEMENT OF FINANCIAL POSITION AT 30 JUNE 2005		
	Note	**2005**
Non-current liabilities		
Long-term liabilities		1 000
Non-current assets		
Property, plant and equipment	1	800
Current assets		
(EFF) Bank balances and cash		200

Note: 1. Property, Plant and Equipment as at 30 June 2005

DESCRIPTION	COST	ACCUMULATED DEPRECIATION	CARRYING VALUE
Item of property, plant and equipment	1 000	200	800
Total	**1 000**	**200**	**800**

Explanatory notes

1. The “EFF: Advances to Services” and “Services: Borrowing from the EFF” will be offset and therefore will not appear in the Statement of Financial Position.

Municipalities have to ensure that all external loans will be repaid on 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 and 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 as interest received.

Example of 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 and equipment. The item of property, plant and equipment has a useful life of 5 years. The item of property, plant and equipment is acquired on 1 July 2004.

The following accounting entries will be processed in the accounting records in the year ending 30 June 2005. As the only difference between government grants and public contributions is the name of the reserve that is created to offset future depreciation, 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

ACCUMULATED SURPLUS					
5	Transfer	1 000	6	Depreciation offset	200

GOVERNMENT GRANTS RESERVE					
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 and equipment.
3. When the item of property, plant and 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 accumulated surplus, equal to the grant received, to the Government Grants 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 and equipment has been fully depreciated.

This transaction will be disclosed as follows in the annual financial statements for the year ending 30 June 2005.

EXTRACT FROM STATEMENT OF FINANCIAL PERFORMANCE FOR THE YEAR ENDED 30 JUNE 2005	
REVENUE	
Government grants and subsidies	1 000
EXPENDITURE	
Depreciation	200

EXTRACT FROM STATEMENT OF FINANCIAL POSITION AT 30 JUNE 2005		
	Note	2005
NET ASSETS		
Government Grants Reserve		800
Accumulated surplus		
NON-CURRENT ASSETS		

Property, plant and equipment	1	800

EXTRACT FROM STATEMENT OF CHANGES IN NET ASSETS FOR THE YEAR ENDED 30 JUNE 2005			
	Government Grant Reserve	**Accumulated Surplus/deficit**	**Total**
Opening balance		a	a
Surplus for the year		b	b
Transfer to Government Grant Reserve	1 000	(1 000)	0
Offsetting of depreciation	(200)	200	0
Total	**800**	**(a+b-800)**	**c**

Note: 1. Property, Plant and Equipment

DESCRIPTION	COST	ACCUMULATED DEPRECIATION	CARRYING VALUE
Property, plant and equipment	1 000	200	800
Total	**1 000**	**200**	**800**

The example above shows when cash is transferred to a municipality to acquire an item of property, plant and equipment by the grantor. 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 and equipment. These different scenarios do not detract from the principles of accounting for property, plant and equipment; ultimately the grant will be recorded as revenue when there has been compliance with the conditions of the grant and a Government Grants Reserve will be created, equal to the value of the grant received, from which to offset future depreciation.

Where an item of property, plant and equipment is donated, either by government or the public, then the item is recorded initially 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.

Example of financing from the capital replacement reserve (CRR)

Assume the following example:

> A Municipality decides to acquire an item of property, plant and equipment costing R1 000 from its CRR. The item of property, plant and equipment has a useful life of 5 years. The item of property, plant and equipment is acquired on 1 July 2004.

The following accounting entries will be processed in the accounting records in the year ending 30 June 2005:

CAPITAL REPLACEMENT RESERVE (CRR)					
2	Utilised to finance property, plant and equipment	1 000			

CRR: BANK/INVESTMENT ACCOUNT					
			1	Purchase	1 000

ACCUMULATED SURPLUS					
			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

Explanatory notes

1. Cash available in the CRR Bank/ Investment Account and is used to purchase the item of property, plant and equipment.
2. A corresponding transfer is made from the CRR to the Accumulated Surplus when an item of property, plant and equipment is acquired using the CRR. The balance of the Accumulated Surplus will be used to finance future depreciation charges to prevent double taxation. The reason is that the CRR has previously been funded from citizens.
3. This is the annual depreciation (R1000 ÷ 5).

This transaction will be disclosed as follows in the annual financial statements of the year ending 30 June 2005.

EXTRACT FROM STATEMENT OF FINANCIAL PERFORMANCE FOR THE YEAR ENDED 30 JUNE 2005	
EXPENDITURE	
Depreciation	200

EXTRACT FROM STATEMENT OF FINANCIAL POSITION AT 30 JUNE 2005		
	Note	2005
NET ASSETS		
Capital Replacement Reserve		0
Accumulated surplus		a+b+1 000
NON-CURRENT ASSETS		
Property, plant and equipment	1	800

EXTRACT FROM STATEMENT OF CHANGES IN NET ASSETS FOR THE YEAR ENDED 30 JUNE 2005			
	Capital Replacement Reserve	**Accumulated Surplus/deficit**	**Total**
Opening balance	1 000	a	1 000+a
Surplus for the year		b	b

Acquisition of PPE	(1 000)	1 000	0
Total	**0**	**(a+b+1 000)**	**c**

Note: 1. Property, Plant and Equipment

DESCRIPTION	COST	ACCUMULATED DEPRECIATION	CARRYING VALUE
Property, plant and equipment	1 000	200	800
Total	**1 000**	**200**	**800**

The purpose of this financing model is to prevent double-taxation. The annual depreciation will be offset by the Accumulated Surplus that has been credited with the transfer from the CRR at the time of acquiring the item of property, plant and equipment.

No interest is capitalised to the CRR. Any interest earned will be credited to revenue and included in the Municipality's Statement of Financial Performance.

The CRR must always be cash backed. When the cash of the CRR is used for other purposes, then the CRR must be reduced accordingly. The CRR will be reduced by the shortfall in cash and the accumulated surplus increased accordingly, using the Statement of Changes in Net Assets 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 all items of property plant and equipment, with the exception of land and heritage assets, be depreciated over the economic life of property, plant and equipment.

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

- Acquisition dates of all items of property, plant and equipment.
- Clear descriptions of individual items of property, plant and equipment
- Depreciation rates determined in accordance with the principles set out in GAMAP 17.
- Historical cost or fair value of individual items of property, plant and equipment or the fair value of assets received as donations.
- Department or Service that uses or controls the item of property, plant and equipment.
- Identification reference for physical verification and asset management purposes.
- Accumulated depreciation attributable to individual items of property, plant and equipment.
- Impairment losses/ gains attributable to individual items of property, plant and equipment.
- Funding source of individual items of property, plant and equipment.
- Where land and buildings are revalued, the revalued amount attributable to individual items of land and buildings.

The Fixed Asset Register should also be able to provide the following information on an annual basis:

- A summary of all acquisitions of property, plant and equipment
- A summary of all disposals or write-offs of property, plant and equipment during the year. The disposals or write-offs information should include both cost and accumulated depreciation
- The aggregate depreciation expense for the year.
- Changes in impairments during the year.
- The opening and closing balances of property, plant and equipment at cost.
- The opening and closing balances of accumulated depreciation.
- Movements in the revalued portion of property, plant and equipment

In addition, the information referred to above should be presented annually by:

- **Class of property, plant and equipment**. This information will be used to prepare the notes to the annual financial statements on property, plant and equipment as well as Appendix B, which are illustrated in the Specimen Annual Financial Statements.

- **Funding source**. This will enable the accounting entries relating to the EFF, CRR, Government Grant Reserve, Capitalisation Reserve as well as the Public Contributions and Donations Reserve to be easily prepared.
- **Department or function**. This will enable the Segmental Information on property, plant and equipment to be prepared that is illustrated in Appendix C of the Specimen Annual Financial Statements.

All items of property, plant and equipment must also be categorised into infrastructure, community, heritage, and other assets as explained in GAMAP 17. These categories are important from a disclosure perspective.
There is a separate section infrastructure assets in this Chapter. There will be different implementation requirements regarding infrastructure and guidance is provided separately from short-life and movable property, plant and equipment.

Performing stock-counts 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 of 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 initially be disclosed in the annual financial statements at cost or fair value. The transitional provision of GAMAP 17 prescribes that on first application of this Standard, property, plant and equipment should be recognised at cost or fair value. There are therefore two ways to determine the values of property, plant and equipment:

- Method 1: At cost. The value of the item of property, plant and equipment will be historical cost less accumulated depreciation less impairment losses; or

- Method 2: At fair value. Fair value is 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 in an arm’s length transaction.

Municipalities that are preparing their Fixed Assets Register may have to use both methods. Initially municipalities should use Method 1 to the extent possible and thereafter apply Method 2. This guideline will provide information on both methods.

Challenges that may be encountered in preparing a fixed asset register

This Chapter sets out typical challenges that municipalities may encounter in preparing standards-compliant fixed asset registers. Suggestions on addressing these challenges are also set out further in this Chapter. As indicated above, determining cost and accumulated depreciation and impairment losses, referred to as Method 1, will be ideal.

However, this may not be possible and Method 2 must then be used. This may be costly but will result in a more realistic and accurate Fixed Assets Register on which to base the annual depreciation charge. Any adjustment to the amount of property, plant and equipment included in the statement of financial position should be adjusted against the opening balance of the accumulated surplus/deficit in the Statement of Changes in Net Assets. The revaluation reserve that will be created will need to be allocated to specific assets and the original global amounts written off.

It should be noted that GAMAP 17, however, only allows for revaluation of land and buildings and not all assets as is required under this option. Revaluation of land and buildings can only be used subsequent to initial recognition (recording in books of account). The revaluation reserve will be retained until the relevant property, plant and equipment is disposed of.

Determining the opening balances of accumulated depreciation on implementation

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

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 easily determined and certain procedures and assumptions will need to be made as illustrated in this Chapter. It is important to note that GAMAP 17 requires that any adjustment to the amount of property, plant and equipment included in the Statement of Financial Position must be adjusted against the opening balance of the accumulated surplus/deficit in the Statement of Changes in Net Assets.

Global amounts

There is also likely to be incomplete data that has arisen 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, which are set out below, when dealing with this challenge:

- Firstly, the municipality can perform an asset count and allocate costs on a pro-rata basis, taking into account 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 is unlikely to be completed before the planned implementation date. There is also a cost implication to this option and the risk of audit query due to the subjective nature of determining asset values.
- An alternative option is to write-off these assets on the basis that these assets are likely to have exceeded their useful lives from a depreciation perspective. It is therefore unlikely that the statement of financial position 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. Any adjustment to the amount of property, plant and equipment included in the statement of financial position should be adjusted against the opening balance of the accumulated surplus/deficit in the Statement of Changes in Net Assets.

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

Incomplete or missing acquisition dates

Acquisition dates are crucial to the calculation of the carrying values of property, plant and equipment at the date of implementing accounting standards. Acquisition dates are paramount to the calculation of accumulated depreciation to date.

Municipalities have a number of options to consider when the acquisition dates of some items of property, plant and equipment are not known, which 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 to determine acquisition dates, it could take considerable time. There will also be a likely cost implication due to a lack of capacity.
- A second option is to physically identify the items of property, plant and equipment in question and, based on visual evaluation, determine a likely acquisition date. This approach may be criticised from an audit perspective, will be time consuming and costly due to the need to in-source capacity. It may also be difficult to identify the specific item 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 easy to implement and will have no cost implications from a capacity perspective.

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

Vague asset descriptions

Municipalities may discover that descriptions of some individual items in the Fixed Assets Register are vague. The implication of these vague descriptions is that it will be difficult to categorise these items of property, plant and equipment and to determine appropriate depreciation rates that will have to be applied to such items.

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. Municipalities should maintain proper information on such write-offs, obtain Council approval and provide suitable evidence to the Auditor-General.

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 to easily 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 will also be a likely cost implication due 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 as well as 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 respect of government grants, the majority of transactions will have only occurred 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 may be costly due to the need to in-source capacity.

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

Infrastructure assets

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

However, it will 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 globular amounts are currently recorded in the current Fixed Assets Register. Acquisition dates and historical cost prices for each infrastructure asset will need to be recorded to enable the calculation of depreciation.

This may not be possible to undertake 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 8 years to prepare this detailed asset information. 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 but cognisance should be taken of the transitional provisions of GAMAP 17 that require the recognition of property, plant and equipment for reporting periods beginning on a date within three years following the date of first adoption of this standard.

Most municipalities will not be able to list all infrastructure assets in the Fixed Assets Register due to the vast extent of the infrastructure. For example, listing every single road and sets of traffic lights will make the Fixed Asset Register unusable. Instead, consideration should be given to dividing the municipal area up into areas, each having a master plan detailing the cost and age of infrastructure in the area. 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 infrastructures 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, due 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 globular 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 pro-rata historical costs to infrastructure based on an averaging method. An example of the 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 then applied.

Adjustments to accumulated depreciation determined at the implementation date can then be made taking into account 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

National Treasury expects municipalities to carefully consider an approach that is appropriate to their specific circumstances in preparing their Fixed Assets Registers. It is of 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.

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 used to establish the Government Grants Reserve and the Public Contributions and Donations Reserve that are now an integral part of the accounting for property, plant and equipment (see Chapter 2).

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 (LROCR)
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 accumulated surplus/deficit.

As part of the unbundling process, it is important to ensure that all external loans are allocated to item 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 the detail of the item of property, plant and equipment financed. It is important to also allocate loans redeemed to specific items of property, plant and equipment when undertaking this process.

This exercise is necessary to ensure that the correct funding source is recorded in the Fixed Asset Register for each individual asset as indicated in Chapter 3.

Overview of the unbundling process

An overview of the unbundling of LROCR is provided in the table below.

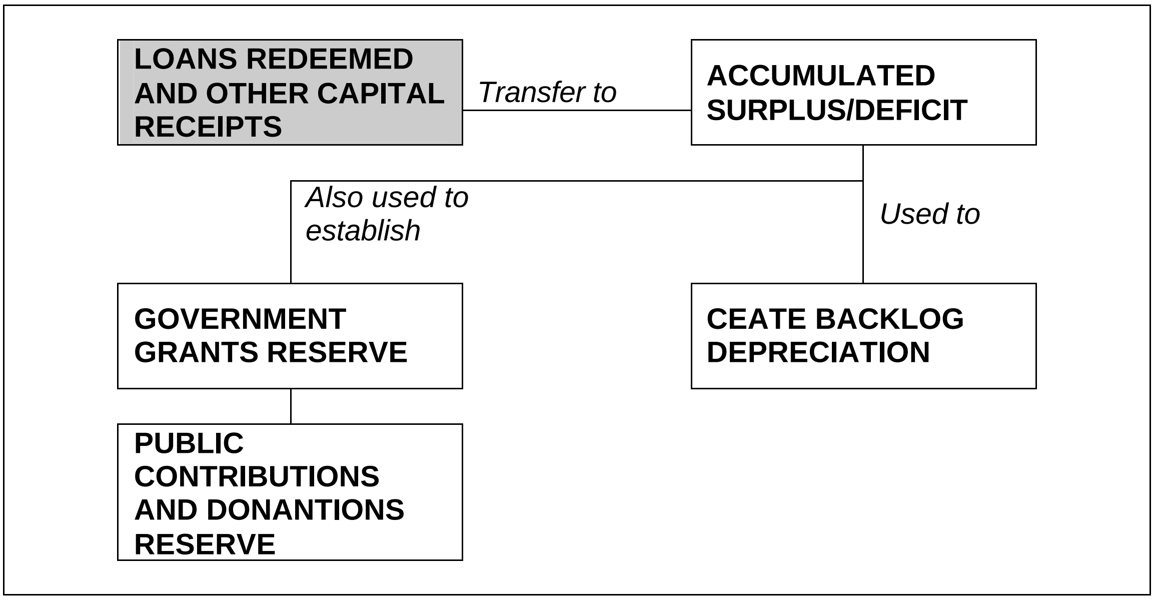
Component of Loans Redeemed and Other Capital Receipts	Process for assets funded there from	Convert to accumulated depreciation	Treatment of residual balance
Revenue Contributions	Determine backlog accumulated depreciation	Allocate corresponding balance of revenue contributions to accumulated depreciation	Balance of revenue contributions to accumulated surplus

Component of Loans Redeemed and Other Capital Receipts	Process for assets funded there from	Convert to accumulated depreciation	Treatment of residual balance
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 Public Contributions and Donations 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 Government Grants Reserve
Other sources of funding (see Note 1 below)	Determine backlog depreciation	Allocate balance of funding to accumulated depreciation	Balance to accumulated surplus

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.

For ease of accounting purposes, the easiest method to unbundle LROCR is to transfer the balance of the LROCR to the accumulated surplus/deficit, recover backlog depreciation from the accumulated surplus/deficit and establish the Government Grants Reserve and Public Contributions and Donation Reserve, if applicable, from the accumulated surplus/deficit.

This is illustrated in the diagram below, where the balance on LROCR is transferred to the accumulated surplus/deficit. Backlog depreciation is created as a charge to the accumulated surplus/deficit. The Government Grants as well as the Public Contributions and Donations Reserves are also created by debiting the accumulated surplus/deficit. This will still achieve the objectives included in the table above but will be easier to process from an accounting perspective.



Once backlog depreciation has been calculated in the Fixed Assets Register, a transfer is made from the Loans Redeemed and Other Capital Receipts through the Accumulated Surplus/Deficit to finance the backlog accumulated depreciation. In addition, a transfer is made to the relevant Reserves 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 accumulated 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 through the accumulated surplus/deficit and the residual transferred to either Government Grants Reserve or Public Contributions and Donations Reserve or the Accumulated Surplus/Deficit.

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 surplus/deficit		50 000
Accumulated Depreciation		45 000
Accumulated surplus/deficit	45 000	

Contributions from Revenue	Debit	Credit
Contributions from Revenue	10 000	
Accumulated surplus/deficit		10 000
Accumulated Depreciation		6 000
Accumulated surplus/deficit	6 000	

Government Grants	Debit	Credit
Government Grants	250 000	
Accumulated surplus/deficit		250 000
Accumulated Depreciation		40 000
Government Grants Reserve		210 000
Accumulated surplus/deficit	250 000	

Public Contributions	Debit	Credit
Public Contributions	25 000	
Accumulated surplus/deficit		25 000
Accumulated Depreciation		18 000
Public Contributions and Donations Reserve		7 000
Accumulated surplus/deficit	25 000	

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 Reserves required in terms of the principles of accounting for Property, Plant and Equipment explained in Chapter 2 will have been created.
-

The “old” financing sources will be renamed to now comply with the financing sources of the new standards. 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) was mandatory in certain provinces and was required by Provincial Ordinances prior to the enactment of the MFMA. The LRF is used to accumulate funds to repay loans on their due date. Municipalities contribute to the fund from the Statement of Financial Performance annually. The LRF always has to be cash-backed.

When new standards are 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 effectively have to be funded from the accumulations in the LRF via the accumulated surplus/deficit.

In practice, the balance of the LRF will be credited to the accumulated surplus/deficit. Backlog depreciation relating to items of property, plant and equipment funded from the external loans and for which the LRF was created, will be charged to the accumulated surplus/deficit. This is similar to the unbundling of LROCR explained earlier in this Chapter.

Conclusion

Once the financing information has been obtained and recorded in the Fixed Assets Register, it is possible to unbundle LROCR as illustrated above. The funding sources of individual items of property, plant and equipment recorded in the Fixed Asset Register can also be determined once the LROCR has been unbundled. In addition, the creation of the Government Grants Reserve and the Public Contributions and Donations Reserve can now also be established.

CHAPTER 5: PROCESS TO ESTABLISH THE CAPITAL REPLACEMENT RESERVE, THE CAPITALISATION RESERVE AND THE EXTERNAL FINANCING FUND

Principles behind the establishment of the capital replacement reserve

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

Municipalities must firstly establish a CRR on the implementation of the standards. Once a draft CRR 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 to cash or investments attributable to the CRR. Where there is insufficient cash or investments, then the balance of the CRR is written down to the balance of cash or investments through the accumulated surplus/ deficit in the Statement of Changes in Net Assets.

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

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

The capitalisation reserve

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

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

These internal loans in the CRR are reversed against the liability reflected in the borrowing services that had received the internal loans. This will result in the assets of the CRR being less than the accumulations in the CRR by the amount of the reversal of the internal loans. An amount is therefore transferred from the CRR, equal to the internal loans reversed, to a Capitalisation Reserve. The Capitalisation Reserve therefore represents amounts previously accumulated that were recovered from consumers through rates and tariffs and that have been used to acquire items of Property, Plant and Equipment. These amounts are therefore not available to be used for any other purpose. In addition, this Reserve aims to promote consumer equity by ensuring that consumers are not subject to double taxation when the items of property, plant and equipment acquired through internal loans are depreciated on the introduction of standards.

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

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

The following process map should be used to establish the CRR where there is no Consolidated Loans Fund (CLF). There is a separate section on unbundling the CLF in this Chapter.

Steps	Procedure
One	Aggregate the existing statutory funds into one account. This is merely the aggregation of similar account balances
Two	Debit the accumulated account by an amount equivalent to the internal investments/internal advances outstanding and credit the Capitalisation Reserve.
Three	Reverse the internal investments/internal advances balance against the various internal loans or advances accounts in the borrowing services
Four	Compare the total of the accumulated fund to the balance of cash or investments attributable to the CRR. Reverse the "unfunded" balance to the accumulated surplus

This process can 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 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 loans made	750			
	TOTAL	1 000		TOTAL	1 000

LAND TRUST FUND					
	External Investments	100		Accumulated Fund	500
	Internal loans made	400			
	TOTAL	500		TOTAL	500

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

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

DRAFT CRR					
	External Investments	350		Accumulated Funds	1 500
	Internal loans made	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 CRR to the Capitalisation Reserve. In addition, the internal investments (advances) 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:

CRR					
	External Investments	350		Accumulations	350
	Internal loans made	0			
	TOTAL	350		TOTAL	350

CAPITALISATION RESERVE					
				Transfer from CRR	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 loans made that were included in the Draft CRR.

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

Where there is no CLF, the process to establish the EFF is relatively simple. Based on the work done on preparing a Fixed Assets Register and Unbundling Loans Redeemed and Other Capital Receipts, it will be possible to determine the external loans outstanding, what has been utilised to finance property, plant and equipment and what is unspent. The various EFF accounts can then be established and maintained as explained in Chapter 2 of this guideline.

Unbundling the CLF to establish the EFF and CRR

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

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. Internal loans of R1 100 have been made to a borrowing service. This borrowing service has recognised this internal loan, 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 loans made 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 SERVICE(RATE & GENERAL SERVICES): INTERNAL LOANS			
		Internal loans from the Consolidated Loans Fund	1 100
TOTAL		TOTAL	1 100

The process to unbundle these accounts is as follows:

Step One: Split internal loans made 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 loans made:	**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 to external loans and the CDF and Land Trust investments in the CLF. This is determined as follows: -

Components	**Total**	**Allocated to internal loans made (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 loans made	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 loans made(J/E1)	450
		External Investment (J/E2)	200
		Internal loans made(J/E2)	150

***Journal Entry 1**: Unbundling CDF*

	Debit	**Credit**
Debit: Investment ex. CDF	525	
Credit: External investments		75
Credit: Internal Loans made		450

***Journal Entry 2:** Unbundling Land Trust Fund*

	Debit	**Credit**
Debit: Investment ex. LTF	350	
Credit: External investments		200
Credit: Internal loans made		150

After processing these 2 journal entries, the CLF will appear as follows:

CONSOLIDATED LOANS FUND			
External investments	0	External loans	500
Internal loans made	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 loans made (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 loans made (J/E2)	150		
TOTAL	**350**	**TOTAL**	**350**

Step Six: Consolidate the CDF and Land Trust Fund into the CRR.

CRR			
External investments	275	Accumulations (525+350)	875
Internal loans made	600		
TOTAL	**875**	**TOTAL**	**875**

The internal advances from internal capital accumulations in the old CLF for the financing of PPE that is still outstanding at the date of unbundling will be transferred to a Capitalisation Reserve. It is that portion of the CRR that can't be cash-backed as it is still tide-up in the funding of PPE. A transfer is made from the CRR to the Capitalisation Reserve. This entry must now be processed.

Step Seven: Transfer amount of CRR used to finance capital

	Debit	**Credit**
Debit: CRR	600	
Credit: Capitalisation Reserve		600

Step Eight: Reverse internal loans made (as CRR does not have internal loans made)

	Debit	**Credit**
Debit: Internal loans made to Rate and General	600	
Credit: CRR Internal loans received		600

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

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

CRR			
External investments	275	Accumulations	875
Internal loans made	600	Step 7 – journal entry	(600)
Step 8 – journal entry	600		
TOTAL	**275**	**TOTAL**	**275**

CAPITALISATION RESERVE			
		Step 7 – journal entry	600

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

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

Conclusion

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

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

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

CHAPTER 6: PROCESS TO RECLASSIFY PROVISIONS AND RESERVES

Rationalisation of liability provisions and reserves

In terms of the definitions of liabilities, liabilities can only be created where there is a present obligation as a result of a past event. It is further probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation and a reliable estimate can be made of the amount of the 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 to meet the requirements of GAMAP 19.

The National Treasury also discourage 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 accounting of property, plant and equipment, 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, the nature of these provisions and reserves may differ. In order to assist municipalities rationalise 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 and 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 accumulated surplus/ deficit 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, then such provisions should not be retained.	These provisions must be reversed to accumulated surplus/ deficit 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 and 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'	Where there are present obligations, amounts should be classified as liabilities and included in the Statement of Financial Position. Where there are no

Example of Provision and Reserve	Principles to be applied	Treatment on Implementation
	contributions, which 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 and equipment. These amounts should not be shown as a provision or reserve.	obligations, the amounts should be transferred to the CRR if there is sufficient cash or transferred to accumulated surplus/ deficit.
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.
Tariff stabilisation reserves	This is taxation in advance of need. There is no present obligation and therefore should not be retained.	These provisions must be reversed to accumulated surplus/ deficit 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 therefore should not be retained. Provisions of section 164 of the MFMA should also be complied with.	These funds or reserves must be reversed to accumulated surplus/ deficit on implementation.
Endowments	These represent revenue and should no longer be accounted for in reserves.	This fund or reserve should be transferred to the CRR if there is sufficient cash or transferred to accumulated surplus/ deficit.
Parking levies/dog licence 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 CRR if there is sufficient cash or transferred to accumulated/ deficit surplus.
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 financial performance of the municipality. However, from a budgeting perspective, it is important that municipalities make provision for future expenditures that will ensure financial sustainability. However, this must be done in a transparent manner. These amounts will be classified as accumulated surplus/ deficit in the annual financial statements.

CHAPTER 7: HOUSING AND TOWNSHIP DEVELOPMENTS

Overview of old scheme 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 to 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 (unless a municipality has been accredited by the provincial department of housing – this is a recent phenomenon). 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 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 Net Assets. In this way, there will be compliance with the housing legislation and new accounting standards.

New scheme

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 therefore the subsidy is 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 new accounting standards, operational transactions will have to be included in the income statement and budgeted accordingly. This may have practical implications due to the long-term nature of such projects but this will need to be managed.

Unbundling 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, which will be accounted for as inventory in terms of GAMAP 12. 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. his will reflect whether historically, surpluses or losses have been incurred on previous property developments.

After the implementation of accounting standards, proceeds from the sale of stands will be recorded as revenue. The unit cost of the stand sold will be recorded as an expense, resulting in either a surplus or deficit on disposal.

Conclusion

Once the 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 ACCOUNTING 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 as Trustee in terms of a Trust Deed, then the assets, liabilities and net assets must be recorded in a Trust Fund. Trust Funds are separate legal entities and as such, separate financial statements should be prepared for each Trust Fund. The various Trust Funds must then be included in the consolidated annual financial statements of the municipality as the municipality controls the various Trust Funds.

There is a need for municipalities to review existing trusts funds disclosed as such in the Statement of Financial Position. Where there is a Trust Deed and the municipality is a Trustee, an assessment will need to be made as to whether or not it is a controlled entity. If it is a controlled entity, the Trust must be in the consolidated annual financial statements of the controlling municipality.

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 amounts should be classified as liabilities in terms of GAMAP 9.
- 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 National Treasury until the conditions of the grant are 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 standards.

This provision must be realistically 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 the standards that has been credited to the accumulated surplus/deficit, to increase their bad debt provision by debiting the accumulated surplus/deficit by the amount required to have a credible bad debts provision. Specifically, where the CRR is adjusted downwards to cash or investment balances attributable to the CRR, the reversal of the CRR should be transferred to accumulated surplus and an amount is transferred from there to the bad debt provision to fully provide for bad debts. The reason is that it is likely that the cash or investments of the former statutory funds that have been amalgamated to create the CRR have been used to finance the increase in debtors' balances.

At the end of each reporting period subsequent to the implementation of the standards, the recoverability of debtors should be assessed and the bad debt provision either increased or decreased. The effect of any increase/decrease in the provision will result in an amount being debited or credited to the bad debt expense in the Statement of Financial Performance.

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 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 new standards, there will no longer be internal interest charged on internal loans or advances from the CRR. 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 met the definition of an expense.

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

Inventories

In terms of GAMAP 12, there are principles set out that define inventory. Most municipalities are not currently applying these principles. For example, unsold water is seldom recognised as inventory. Where municipalities control unissued medicines or have emergency stores, these are also seldom recognised as inventory.

On the implementation of the standards, municipalities will need to investigate the extent to which there is inventory that was previously unrecorded and which should now be recorded to comply with GAMAP 12. Where such inventory is identified and valued according to the principles of GAMAP 12, an adjustment is made to the accumulated surplus/deficit.

CHAPTER 9: PREPARING INITIAL STANDARDS-COMPLIANT ANNUAL FINANCIAL STATEMENTS

The accounting standards implementation process

The implementation of standards is a change in accounting policy and must therefore be implemented in accordance with the provisions of GRAP 3. In most cases, the standards must be implemented retrospectively and the comparative amounts in the annual financial statements in the first year of implementation restated accordingly.

In certain cases, it will not be possible to restate comparatives when converting to new standards. This Chapter will set out an alternative approach that is in accordance with the requirements of GRAP 3.

The following diagram illustrates the implementation process assuming that the date of first-time implementation is 1 July 2004 (i.e. the effective date).

Year ended 30 June 2004	Implementation Process	Implementation as at 1 July 2004	Year ending 30 June 2005
Fund Accounting Balance Sheet	*Opening balance as at 1 July 2003 determined in terms of new standards*	Restated Statement of Financial Position	New standards Statement of Financial Position
Fund Accounting Income Statement	*Revenue and expenses for the year restated in terms of new standards*	Restated Statement of Financial Performance	New standards Statement of Financial Performance
Fund Accounting Cash Flow Statement	*Cash flow statement prepared in terms of GRAP 3*	Restated new standards Cash Flow Statement	New standards Cash Flow Statement
Transactions/events restated to new standards		*Transactions/events in terms of new standards*	

In terms of this diagram, the previous fund accounting balance sheet must be restated at the beginning of the comparative period, which will be 1 July 2003 and a new standards compliant Statement of Financial Position will be prepared at that date.

The revenue and expenses for the year ended 30 June 2004 will be restated in accordance with the new standards and a restated Statement of Financial Performance for the year ended 30 June 2004 will need to be prepared. New standards compliant Statement of Financial Position will also be prepared as at 30 June 2004. Transactions and events subsequent to the date of implementation, 1 July 2004, will be recorded in accordance with the new standards and a standards compliant Statements of Financial Position and Financial Performance will be prepared as at 30 June 2005 and for the year ending 30 June 2005 respectively. When preparing the annual financial statements for the year ending 30 June 2005, the restated comparatives will be included in such annual financial statements.

Reconciliation of previously reported balances

A reconciliation must be included in the initial standards compliant annual financial statements showing the adjustments arising from the implementation of the standards. This reconciliation must show what adjustments were made to all account balances that were included in the Statement of Financial Position in the previous fund accounting annual financial statements.

Assuming for example that additional inventory was recognised due to the application of GAMAP 12. The following reconciliation will be disclosed in the initial standards compliant annual financial statements.

Change in Accounting Policy: Implementation of the standards

Inventory
Inventory previously reported (in the previous fund accounting annual financial statements)
Add: Additional inventory recognised due to application of GAMAP 12
Equals: Restated inventory balance on the implementation of the standards

Accumulated Surplus/Deficit
Balance previously reported (in the previous fund accounting annual financial statements)
Add: Additional inventory recognised due to application of GAMAP 12
Equals: Restated accumulated surplus/deficit on the implementation of the standards

The sum of all the adjustments processed against the accumulated surplus/deficit will constitute the net effect of the change in accounting policy arising from the implementation of the standards that will be recorded in the Statement of Changes in Net Assets.

It is therefore important that all adjustments arising from the implementation of the standards are recorded in the accounting records to support the reconciliations included in the initial annual financial statements.

This reconciliation must be included in the initial standards compliant annual financial statements, regardless of whether or not comparatives can be restated. If comparatives can be restated, these reconciliations will show the adjustments made at the beginning of the year in the comparative period. If comparatives cannot be restated, this reconciliation will show what adjustments were made to previously reported balances as at the effective date of implementation.

Restating comparatives

As mentioned above, in order to prepare annual financial statements that comply with GRAP 1 and GRAP 3, comparative amounts must be presented in the initial standards compliant annual financial statements prepared by a municipality. This means that the implementation of the standards should be done one financial year before the effective date as explained above. This will enable comparative amounts to be included in the initial standards compliant annual financial statements.

However, it is recognised that this may not be possible due to extensive adjustments that may have to be made to the historical accounting records prepared in terms of the fund accounting on the implementation of the standards In order to restate comparatives, extensive adjustments that are processed to the Fixed Assets Register or LROCR, for example, will need to be allocated to the comparative period and to the periods before the comparative period. It may not be possible to determine to which periods the extensive adjustments relate; indeed certain of the `adjustments may relate to the comparative period but this is not possible to determine. The only certainty is that the need for the extensive adjustments arose before the effective date of the implementation of the standards.

Where the extensive adjustments that have been processed cannot be allocated to the comparative period or the periods prior to the comparative period, then it will not be possible to restate comparatives at the beginning of the comparative period. This means that a comparative Statement of Financial Performance and a comparative Statement of Changes in Net Assets cannot be prepared in accordance with the standards. An alternative Statement of Financial Performance and Statement of Changes in Net Assets will have to be prepared. These alternative statements are illustrated in the Specimen Annual Financial Statements issued by the National Treasury.

There will have to be compliance with GRAP 3, which requires that annual financial statements set out the circumstances that prevented retrospective application and a description of how and from when the implementation of the standards has been applied.

It should be noted that it would always be possible to prepare comparatives for the Statement of Financial Position, as accounting standards will always be implemented on 1 July. In order to implement accounting standards, the Statement of Financial Position has to be converted from fund accounting to GRAP standards on that date, thereby creating comparative information.

The Alternative Statement of Financial Performance

When comparative information cannot be prepared in accordance with the standards, the information included in the previous fund accounting annual financial statements is disclosed as comparatives to mirror the initial standards compliant Statement of Financial Performance to the extent possible.

It should be noted that there would not be a comparative for “depreciation”.

This is illustrated in the table below. The table only illustrates revenue and expenses where adjustments will have to be made to the comparative amount in terms of fund accounting.

Transaction	Adjustments Required to Comparatives
REVENUE	
External investment Interest	In fund accounting, external investment interest may have been paid directly into statutory funds and

	reserves. All external investment interest earned in the comparative period must be included as revenue and shown as a comparative.
Government Grants	In fund accounting, conditional government grants used to acquire items of property, plant and equipment will have been credited to LROCR. These government grants, to the extent that conditions were met, must be included as revenue in the comparative period.
Public Contributions and Donations	In fund accounting, public contributions and donations used to acquire items of property, plant and equipment will have been credited to LROCR. These amounts must be included as revenue in the comparative period.
Gains on the disposal of property, plant and equipment	These amounts will have been credited directly to a statutory fund. Gains must now be included as revenue in the comparative period.
Transfers from statutory funds and reserves	These are internal transactions and are excluded from the comparative period.
EXPENSES	
Internal loan interest	This is an internal transaction and is therefore excluded from the comparative period.
Internal loan redemption	This is an internal transaction and is therefore excluded from the comparative period.
External loan redemption	This is not an expense in terms of the standards and therefore is excluded from the comparative period.
Contributions (to capital outlay, statutory funds and	This is not an expense in terms of the standards and therefore is excluded from the comparative period.

Once these adjustments have been processed, the surplus or deficit in the comparative period will differ to that reported in the previous fund accounting annual financial statements. These adjustments are subsequently reversed in the comparative period in the Statement of Changes in Net Assets "Accumulated Surplus/Deficit". The reversal of these adjustments aggregated with the surplus or deficit in the comparative period will equal the surplus or deficit previously reported in the previous fund accounting annual financial statements.

The comparative amounts included in the initial standards compliant annual financial statements will be comparable to the new standards revenue and expenses to the extent possible.

An alternative Statement of Financial Performance is included in the Specimen Annual Financial Statements issued by the National Treasury.

The Alternative Statement of Changes in Net Assets

The comparative amounts for the alternative Statement of Changes in Net Assets will be based on the changes to the statutory funds, reserves and the accumulated surplus processed in the previous fund accounting annual financial statements. For example, the information in Appendix A of the IMFO financial statements will be summarised in the comparative period of the Statement of Changes in Net Assets. The prior year adjustments and appropriations included in the previous fund annual financial statements will also be summarised in the Statement of Changes in Net Assets.

The closing balances in the Statement of Changes in Net Assets in the comparative period must equal the balances that were adjusted to implement standards in the new standards reporting period.

In the Statement of Changes in Net Assets, the statutory funds and reserves shown in the previous fund accounting financial statements should be aggregated and shown as "Pre-standards Funds and Reserves".

An alternative Statement of Financial Performance is included in the Specimen Annual Financial Statements issued by the National Treasury.

The scope of accounting standards and accounting policies

Reference should be made to National Treasury's MFMA Circular No 18 before reading this section of the guideline.

Municipalities will have transactions and events that are not covered by both GRAP and GAMAP standards which have been issued and are listed in Chapter 1 of this guideline. ***Municipalities must develop and disclose accounting policies for all material transactions and events in their annual financial statements***.

In respect of those transactions and events that are included in either a standard of GRAP or GAMAP, there must be compliance with the recognition and measurement criteria in those standards, which will be the basis of the accounting policy specific to that transaction or event, as well as compliance with the disclosure requirements specified in such GRAP and GAMAP standards.

Mandatory accounting policies

In the Specimen Annual Financial Statements issued by the National Treasury, the accounting policies based on GRAP and GAMAP are shown as mandatory accounting policies. There are also other accounting policies that are mandatory accounting policies but which are not covered by the scope of the GRAP and GAMAP standards. These additional accounting policies are deemed to be important to ensure that there is consistency by municipalities in the presentation of annual financial statements. The Specimen Annual Financial Statements also illustrate the compulsory disclosure requirements of the GRAP and GAMAP standards together with the compulsory disclosure requirements of the Municipal Finance Management Act.
It should be noted that a municipality will require an exemption from National Treasury if it cannot comply with the requirements of the approved GAMAP and GRAP standards. In addition, it will have to disclose in its annual financial statements that it has been exempted from a provision of a standard or from a standard and disclose the reasons and the effect of the exemption.

Encouraged accounting policies

Municipalities are encouraged to adopt the recognition and measurement criteria included in other accounting conventions to achieve fair presentation where there are transactions and events not included in the scope of the GAMAP and GRAP standards. Guidance can be obtained from GRAP standards approved by the ASB but not yet gazetted by the Minister of Finance, International Public Sector Accounting Standards (IPSAS), International Accounting Standards (IAS) and Generally Accepted Accounting Practice (GAAP), in that order.

The advantage of using these existing pronouncements is that the necessity to change accounting policies when standards of GRAP are subsequently implemented is reduced. However, it should be noted that municipalities are not required to comply with the disclosure requirements of these standards.

The Specimen Annual Financial Statements issued by National Treasury set out encouraged accounting policies. Whilst municipalities are encouraged to apply the accounting policies, it is not mandatory and the municipality should not receive an audit qualification from the Auditor-General if not applied. However, the municipality will still need to have an accounting policy for each transaction or event.

Conclusion

It is the responsibility of all municipalities to ensure that their annual financial statements fairly present their financial position, financial performance and cash flows to the extent possible. There is an understanding that due to the challenges of moving from fund accounting to the new accounting standards convention, it will take time before municipalities' annual financial statements achieve fair presentation.

CHAPTER 10: 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 accounting standards so that municipalities are able to amend their accounting procedures and records once the standards have been implemented. In order to facilitate this process, brief comments have been made on each GRAP and GAMAP standard as at the date of this guideline.

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

GRAP 1: Presentation of financial statements

National Treasury has prepared Specimen Annual Financial Statements illustrating the requirements of this accounting standard. These Specimen Annual Financial Statements should be used to understand this accounting standard.

GRAP 2: Cash flow statements

Cash Flow statements are only prepared for annual financial statement reporting purposes. However, it is important to note that municipalities must 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 cashbooks to enable this information to be easily obtained at year-end for the purposes of preparing their annual financial statements.

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 transaction are in accordance with the accounting policies described in the annual financial statements. Again, reference should be made to the Specimen Annual 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 GRAP and GAMAP standard provides guidance on the accounting treatment of transactions and account balances and the prescribed treatments will constitute the accounting policy of the municipality.

There are two sets of accounting policies included in the Specimen Annual Financial Statements. One is referred to as the mandatory accounting policies whereas and the other encouraged accounting policies. High capacity municipalities have to comply with GRAP1, GRAP 2 and GRAP 3 and the 8 GAMAP Standards for all annual financial statements that will be prepared for the year ending 30 June 2006. Municipalities must include the accounting policies applied where transactions are not covered by the mandatory standards.

Municipalities are encouraged to comply with the encouraged accounting policies illustrated in the Specimen Annual Financial Statements issued by National Treasury. The encouraged accounting policies are the policies to be applied where there are no GRAP and GAMAP standards issued by the ASB and approved by the Minister of Finance. Municipalities are advised to refer to paragraphs 7, 11 and 12 of GRAP 3 for guidance where they have material transactions that are not covered by the existing accounting standards. Each year, as additional new accounting standards are issued, the number of mandatory standards, with which municipalities must comply, will increase.

The accounting policies included in the Specimen Annual Financial Statements are for guidance purposes only. Accounting policies of each municipality must be in terms of the GAMAP and GRAP Standards and must be approved by the Municipal Council. Where subsequent changes to accounting policies are made, there must be compliance with the requirements of this accounting standard.

A post-standards implementation implication of GRAP 3 is that the concept of prior year adjustments used previously has been discontinued and no adjustments other than changes in accounting policies and correction of errors may be processed against the accumulated surplus/deficit in the Statement of Changes in Net Assets. 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 4: The effects of changes in foreign exchange rates

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

GAMAP 6: Consolidated financial statements and accounting for controlled entities

This accounting standard will have implementation ramifications. Chapter 8 sets out these implications in more detail. National Treasury will soon issue Specimen Consolidated Annual Financial Statements that should be studied for more detail.

GAMAP 7: Accounting for investments in associates

This accounting standard 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 8: Financial reporting of interests in joint ventures

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

GAMAP 9: Revenue

There are major ramifications arising from this standard. Conditional capital grants are recorded as revenue as described in Chapter 2, which explains the principles of accounting for property, plant and equipment.

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 as 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 12: Inventories

The only post-implementation implication of this accounting standard is that municipalities need to ensure that all inventory, as defined in the accounting standard, is 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, which are material, are recorded as such.

GAMAP 17: Property, plant and equipment

This accounting standard 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 to continually update it thereafter. Chapter 3 provides guidance on updating the Fixed Assets Register.

A further implication of this standard 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. Conversely, when the proceeds are greater than the carrying value of property, plant and equipment disposed, 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.

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.

CHAPTER 11: CONCLUDING SUMMARY OF THE GRAP AND GAMAP IMPLEMENTATION PROCESS

Summary of the GRAP and GAMAP 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 at 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 CRR and EFF from the existing statutory funds, provisions and reserves.

These tasks constitute the majority of the work that is involved in implementing the standards.

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

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

Compliance with the GRAP and GAMAP accounting standards

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

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

Early implementation of accounting standards

Chapter 1 sets out the implementation dates of accounting standards. Notwithstanding these dates, municipalities are encouraged to put processes and systems in place to implement the standards as soon as possible.