Funding Compliance Policy

2015/2016

Introduction

This guideline further clarifies the meaning of the MFMA's 'funding' compliance requirements, and is also in response to comments and questions received regarding the application of some MFMA requirements and MFMA Circular 42.

There has been a common misconception that GRAP/GAMAP compliant 'accounting' is a proxy for a funding strategy. MFMA Circular 42 attempted to dispel this belief, but this message may take some time to disseminate and reinforce. Some of the key reasons an 'accounting' approach is difficult to apply are:

- Any analysis of the Financial Performance Budget 'Result' is reliant on key underlying assumptions; e.g. debtors' collection rates, growth rates, consumption changes etc, which also need to be proven as credible and realistic before adherence to MFMA 'funding' requirements can be attested to;
- The terms 'realistic and credible', especially as the terms relate to sustainability, require the interpretation of a wide range of assumptions and outcomes;
- Accrual budgeting requires accounting for liability provisioning, but in many cases (except in minority of mandatory situations) the strategy for funding the future obligations recognised by the provision is a separate decision and approval process;
- Complexity

Budget funding that conforms to MFMA requirements, ensuring adherence with various provisions of the MFMA, should be multi-faceted in achieving a number of financial management objectives, including:

- MFMA compliance, in particular to sections 18 and 19;
- Short term viability and consideration of the community 'paying its way' relative to economic benefits received;
- Medium and long term sustainability; ensuring that the broader community maintains control over outcomes within appropriate levels of affordability (which is likely to be different for every municipality);
- Achievement of community aspirations and service delivery goals;
- Maintenance of a good credit rating and minimising financing costs; and
- Achieving and maintaining key prudential measurements; e.g. borrowing limits.

MFMA

Sections 18 and 19 include the following requirements:

An annual budget may ***only*** be funded from:

- ***realistically*** anticipated revenues ***to be collected***;
- cash-backed accumulated funds from previous years' surpluses ***not committed for other purposes***; and
- borrowed funds, but only for the capital budget referred to in section 17(2).

Revenue projections must be ***realistic*** taking into account:

- projected revenue for the ***current year*** based on collection levels to date; and
- actual revenue collected in ***previous financial years***.

A municipality may spend money on a capital project only if the sources of funding have been considered, are available and have ***not been committed for other purposes***.

Funding compliance overview

The methodology advocated for ensuring funding compliance is an 'iterative' process, required to be initially undertaken as a self-assessment by municipalities as part of the budget development process. Non-achievement of the required standard of any of the analysis factors may require that aspects of a budget be revisited until 'full compliance or substantiation' is achieved. A budget should not be tabled until this rigour has been fully applied and the appropriate standards achieved and substantiated.

Budget format table A10 ('Funding measurement') contains 14 factor measures derived from information from the Annual or Budgeted Statements of Financial Performance, Financial Position and Cash Flows. A template to be provided, as part of the 'Budget formats' (table A10); will calculate the measurements when the budgeted financial statements have been completed. Refer Annexure **A for** an illustration of a draft format of the Table A10 template. Similarly, budget format table A8 ('Performance indicators and benchmarks') are also automatically calculated. The full funding compliance methodology contains 18 factors that can be all answered by reference to measurements contained in Table A10, Table A8 and the Budgeted Financial Statements.

The sequence of the factors is deliberate, progressing from solvency to sustainability. The initial factors focus on cash fundamentals, then factors relating to collection rates and revenue growth, and finally with factors about the revenue protection and overall financial outcome measures. An aim is to keep the number of factors to the minimum level that can provide a Council and other stakeholders with compliance confidence without becoming overly unwieldy and complex, although it is accepted that a range of other factors also could be included in such an analytical tool. Initial tests on a number of municipal budgets indicates that, as a by-product of the budget development process, the procedure is relatively straight-forward and easy to complete once the budgeted financial statements have been assembled.

This analytical tool is an iterative process, meaning that when a response to a factor is unfavourable, or cannot be appropriately substantiated, it is expected that the budget would be revised until the answer is favourable. However, many of the measurements are inter-related, so a revision of the budget would require that a review of the measurements be recommenced from the beginning to ensure that all outcomes are still favourable. A municipality testing its budget should not progress to another measurement in the sequence until a favourable outcome is achieved on the current measurement being reviewed. A favourable outcome in some instances is the substantiation or motivation in the municipality's budget document.

The selection of measures applied are also deliberately based upon information sourced only from budget documents or audited annual financial statements, to ensure relative ease of calculation and that the measurements can be independently calculated and verified by stakeholders external to the organisation. For example, the version of the collection rate used is the actual or budgeted cash receipts from the revised format Cash Flow Budget (or statement) and the total of ratepayer and other revenue (much of which is cash collections and therefore a collection rate is always 100 percent) from the Financial Performance Budget (or statement). This will be a different result to a collection rate of only cash from consumer debtors related to consumer debtor billings, depending on the proportion of 'other revenue' cash billings and collections. The difference is not significant as a key focus is on individual

municipal collection performance and trends, and is a preferable approach to requiring even greater cash collection information disclosure and the related inaccuracies that may cause. Especially as the volatility of the collection rate caused by the generally-accepted approach of the inclusion of arrear debtors in the cash collection rate is more significant.

The following table lists the factors that are to be reviewed. Each of the factors is then further described below.

No.	Funding Compliance
1	Cash/cash equivalent position
2	Cash plus investments less applications
3	Monthly average payments covered by cash or cash equivalents
4	Surplus/deficit excluding depreciation offsets
5	Property Rates/service charge revenue % increase less macro inflation target
6	Cash receipts % of ratepayer and other revenue
7	Debt impairment expense % of billable revenue
8	Capital payments % of capital expenditure
9	Borrowing as a % of capital expenditure (less transfers/grants/contributions)
10	Transfers/grants revenue as a % of Government transfers/grants available
11	Consumer debtors' change (Current and Non-current)
12	Repairs & maintenance expenditure level
13	Asset renewal/rehabilitation expenditure level
14	Financial Performance Budget result
15	Financial Position Budget
16	Cash Flow Budget
17	Other key performance measures
18	Summary question

Funding compliance factor description

A completed 'Funding Measurement' assessment supports this procedure. Refer to the budget format requirements determined by National Treasury.

Each of the factors is further described below. These 'funding factor' descriptions should be reviewed in their entirety prior to undertaking any analysis.

Analyse each factor in sequence. If a factor appears unfavourable and cannot be adequately motivated, adjust the budget appropriately and begin the analysis again from the first factor. The final step is an overall review to ensure that all measures either meet the specified requirements or have been appropriately motivated in the budget document

1. **Cash/cash equivalent position:** the municipality's forecast cash position is fundamental. A 'positive' cash position, for each year of the medium term budget would generally be a minimum requirement, subject to the planned application of these funds such as cash-backing of reserves and working capital requirements (refer factor 2).

   If the municipality's forecast cash position is negative, for any year of the medium term budget, the budget is unlikely to meet MFMA requirements or be sustainable and could indicate a risk of non-compliance with section 45 (short term debt). A

revision of budgeted revenue and/or expenditure, and funding, is required to improve cash forecasts.

2. **Cash plus investments less application of funds:** The purpose of this measure is to understand how the municipality has applied the available cash and investments identified at factor 1. The budget formats contain a table that reconciles the amount of cash and investments (including non-current investments) compared to the past application and budgeted application of funds. The reconciliation is intended to be a relatively simple methodology for understanding the budgeted amount of cash and investments available with any planned or required applications to be made. These applications are defined as:
   - Unspent conditional transfers/grants and receipts - a municipality may have received an advance of cash for which conditional expenditure had not occurred by the end of the year being analysed. This is most common for capital expenditure funded by government transfers. Government transfers/grant revenue will only have been recognised to the extent it had been 'earned'; i.e. that conditions had been met, such as capital expenditure incurred for the purposes for which the conditional transfer/grant was provided. Any unspent funds are considered a liability to the transferor until such time as the conditions are met usually being the expenditure has been incurred, regardless of the likelihood of having to repay the funds if the conditions are not met. Municipalities should not budget for unspent transfers.
   - Unspent long term borrowing - long term borrowing may only be incurred for the purposes of capital expenditure or refinancing of borrowing under restricted conditions (MFMA section 46(5)). Borrowing is usually undertaken on a tender basis and one tender may relate to an entire year's capital program or sometimes a multi-year appropriation. If the capital program to be funded by borrowing has not been completed within a financial year there should be unspent borrowing which must be cash-backed until the capital expenditure is incurred and the payments made provided the loan funds have been fully drawn down. A good practice would be only draw down loan funds in the year they are needed, but this may not be practical for some loan types; e.g. bond.
   - Value Added Tax (VAT) - VAT collected and funds due to SARS. In some instances it is possible that the amount of VAT credits claimed offset any funds collected.
   - Other working capital requirements - working capital will likely be required to fund any timing mismatch between revenue receipts, and payments being made. For example, employee remuneration and trade creditor payments would have to be paid on a 30 day basis, but collection of debtors' revenue may average over a longer period. Therefore, a reasonable estimate needs to be made of the funding gap (which is the minimum working capital requirement) that will occur. The calculation to support the measurement should be based on the proportion of service charges and other debtors expected to be collected with 30 days. The average collection rate could be used to calculate the amount, or a more accurate seasonal collection rate if available.
   - Other provisions of funds - provisions may have been made that require some level of cash backing. A municipality should have a budget policy to guide it on the level of cash-backing for such provisions as 'debt impairment' (bad/doubtful debts). There may be other provisions such as self-insurance, employee injury, pension plans, post-retirement medical aid and landfill site rehabilitation that require a strategy program for funding. In some of these circumstances the entire amount of a provision may not need to be fully cash-backed immediately.

Care needs to be taken to ensure that the rate such funds are accumulated is equitable relative to the level of tariffs and taxes the community is being asked to pay; for example: it would likely be inequitable to fund the future rehabilitation of a refuse disposal site from a once-off increase to taxes and tariffs, when the liability was incurred progressively over many years.

- Long term investments committed - there may be other funds that have been committed for which long term investments have been set aside. A common example is the holding of 'sinking funds' for the repayment of future borrowing liabilities. The creation of sinking funds is often a condition of a borrowing by the originating financial institution of the loan. The 'sinking' funds sometimes may not be utilised for other purposes, even on a temporary basis, without being in breach of the borrowing agreement.
- Reserve funds - there may be legal obligations to hold funds in special reserve funds, e.g. Housing Fund. Also, as mentioned previously under the section on 'other provisions' Council may have resolved to progressively set aside certain funds into a reserve fund to meet future obligations

After including calculations for all applications of funds the 'funding balance' should be reviewed. If there is a cash shortfall (negative) in any of the 3 years of the budget there needs to be a revision until such time as at least a break-even funding position is achieved. An overall cash shortfall is indicative that the MFMA is not being complied with, that expenditure budgets are not funded. A shortfall would not exist if the budget was funded in accordance with MFMA section 18(1). However, if there is a surplus of cash, over the medium term or in any budget year, there should not be an automatic assumption that revenue is too high. Firstly there needs to be an examination of the future cash position. It is becoming more common for municipalities to have long term financial strategies, which incorporate estimates for a number of years beyond the medium term budget. One advantage of these strategies is that they highlight the need for sustainable levels of capital expenditure and borrowing (borrowing levels that can be repaid on the maturity date). An examination of longer term obligations may reveal significant cash outflows in year beyond the MTREF.

3. **Monthly average payments covered by cash or cash equivalents**: the purpose of this measure is to understand the level of financial risk should the municipality be under stress. Regardless of the annual cash position an evaluation should be made for the ability to meet monthly payments as and when they fall due. It is especially important to consider the position should the municipality be faced with an unexpected disaster that threatens revenue collection. A useful indicator for this is included in Table A10 which is known as the 'cash coverage ratio'; i.e. the number of times average monthly payments are covered, calculated by dividing the estimated average monthly payments into the available cash balance.

   A municipality should also consider whether the 'cash coverage ratio' exhibits negative 'trend' characteristics; i.e. the ratio depicts a deteriorating trend compared to previous years? A low or reducing ratio may indicate an inability to meet payment obligations when they fall due, although the individual circumstances of municipalities is a key consideration; i.e. municipalities which do not have a heavy reliance on the collection of services revenue may have less of an exposure to disaster. In this instance trend analysis would be of greater importance. The ratios of comparable municipalities may assist in an assessment.

A low or reducing ratio would require that either the budget is revised to improve the cash position to an acceptable level, or a comprehensive justification included in the budget document.

4. **Surplus/deficit excluding depreciation offsets**: the main purpose of this measure is to understand if the revenue levels are sufficient to conclude that the community is making a sufficient contribution for the municipal resources consumed each year. An 'adjusted' surplus/deficit is achieved by offsetting the amount of depreciation related to externally funded assets. It is contended that if gross depreciation is included in the Financial Performance Budget to determine tariff levels the community is being taxed twice for the same expenditure; i.e. paying tax to the national government which is used to fund transfers to support specific capital budgets and then paying tax (property rates) to the municipality to fund the depreciation related to the asset that was funded by the transfer. A similar argument can be mounted where property developers provide infrastructure. The issue with this contention is that if/when the assets have to be replaced in the future the national funding may not be available. Municipalities need to assess the result of this calculation taking into consideration its own circumstances; i.e. the ability to fund depreciation may be a different issue for a rapidly growing municipality faced with major service delivery backlogs compared to one that is well established and experiencing slow growth.

   A municipality should analyse whether the Financial Performance result (surplus/deficit), adjusted for 'offset depreciation', is a deficit for any or all of the years of the medium term budget. A deficit may indicate that tariffs and taxes are insufficient to ensure that the community is making a sufficient contribution toward the economic benefits they are consuming over the medium term budget period. Tariffs and property tax increases may have to be reviewed simultaneously with a consideration of a reduction in expenditure to improve the result. Alternatively a comprehensive justification should be discussed in the budget document; e.g. a phased increase or realignment in tariffs may require acceptance of a deficit to be later compensated for by a progressive move to a surplus position through staged tariff increases or realignment of the revenue mix.

   A surplus situation does not obviate the need to comply with cash requirements measured by factor 2.

5. **Property Rates/service charge revenue % increase less macro inflation target:** the purpose of this measure is to understand whether the municipality is contributing appropriately to the achievement of national inflation targets. This measure is based on the increase in 'revenue', which will include both the change in the rate or tariff as well as any assumption about real growth (i.e. new property development, services consumption growth). Importantly recall that non-achievement of the macro benchmark of this and other analysis factors may require that aspects of a budget be revisited until 'full compliance or substantiation' is achieved.

   The factor is calculated by deducting the maximum macro-economic inflation target increase (as advised annually by National Treasury circular; currently 3 - 6 per cent) from the total projected growth (increase) in revenue. The result is intended to be an approximation of the real increase in revenue. This 'real increase' should be compared with the projected underlying city growth and consumption growth to

justify the increase. Recent trends should also be analysed. For example there may be an average 1 per cent increase from new taxable property value and a 2 per cent increase in electricity/water consumption by existing consumers, with a similar trend in the previous financial year. If the total growth and consumption increase shown by the measurement for the proposed budget is even greater then this measurement outcome this will be considered evidence of the proposed tax/tariff increases exceeding macro-economic inflation targets, in which case the budget should either be revised or the budget document would need to thoroughly substantiate the extraordinary increase.

To undertake the analysis a municipality should firstly, compare the percentage increase in property rates and service charge revenue with the macro inflation target for the budget year. Secondly, ascertain an estimate of projected real city growth and services' consumption growth. Finally, ascertain the projected CPIX for the budget years.

If the proposed budget increase exceeds the macro inflation target and/or the projected CPIX then the increase would need to be motivated in the budget document as the community will have an expectation that increases do not exceed CPIX changes. Where, the increase also exceeds city and consumption growth projections, consideration should be given to revising the budget or, alternatively thoroughly motivating the revenue increase including a description of the consultation program proposed to gain acceptance from the community.

There will be instances where external influences create pressure for justifiable revenue increases in excess of the macro target. Examples may include sanctioned national local government salary increases or bulk service provider price increases, such as electricity and water, over which local government has minimal input. These increases have a different impact on individual municipalities, and therefore need to be motivated widely within communities.

6. **Cash receipts % of ratepayer and other revenue**: this factor is a macro measure of the rate at which funds are 'collected'. This measure is intended to analyse an underlying assumed collection rate; i.e. how much cash is expected to be collected from current billing, charges and arrear debtors? The first part of the analysis is to compare the percentage with the current and prior year trends. If the percentage is much higher than recent trends then it is highly probable that the cash collection rate assumptions do not comply with section 18 of the MFMA, as it is probable that the 'anticipated revenues to be collected' are unrealistic. Trends in recent months should also be considered to ascertain if these are consistent with the average annual trend. If the percentage is greater than 100 per cent then this could indicate that the municipality is improving the collection of arrear debt. This plan would have to be well substantiated.

   The analysis should firstly compare the projected collection rate with the overall year-to-date outcome of the 'current year' (the financial year during which the budget is being prepared). Secondly, the projected collection rate should be compared with the outcome for the 'prior' financial year. Finally, compare the projected collection rate with a more 'recent' trend; e.g. the collection trend of only recent months in the current financial year. The proposed budgeted collection rate must be realistic in terms of all of the comparisons.

The MFMA (section 18(2)) is very definitive on the issue of realistic revenue collections, only allowing the budget to be formulated on the basis of proven collection rates in the current and previous years. Therefore, if the projected collection rates for the budget are greater than the current year, including recent trends in the current year which would be incorporated into the projection for the current year, or the collection rates experienced in previous financial years, then this is evidence that the cash collection assumptions do not comply with section 18 of the MFMA. Collection rate projection assumptions should be revised, or alternatively a detailed justification made for the increase. If the collection rate projection cannot be substantiated then the collection rate assumptions and cash flow forecasts should be reviewed and based only on current and previous years' experience.

Plans or collection policy changes should not be relied upon as justification until such time as actual improved collection performance is proven. If in doubt, a municipality must apply the realistic approach and, if favourable collections actually eventuate, then review the situation as part of the next mid-year budget and performance assessment or re-consider the situation during the next budget cycle.

7. **Debt impairment expense % of billable revenue** - this factor is to measure whether the provision for debt impairment is being adequately funded and is based on the underlying assumption that the provision for debt impairment (doubtful and bad debts) has to be increased to offset under-collection. The measure needs to compare budget projections with recent current year and monthly trends to have confidence that a realistic provision is being included. Collection of arrear debt, and policies related to the adequacy of the total provision make the assessment of an adequate provision somewhat complex. Historical trends of the municipal 'bad debt' expense may be influenced by adjustments for individual financial year outcomes. However, if the projected collection rate of billable revenue is less than 100% it can generally be expected that an increase to the provision will be required to offset the collection shortfall. It may also be the case that past improved collection performance results in an 'over'-provision.

   If the debt impairment expense percentage of billable revenue is inconsistent with forecast collection rates discussed at factor 6; i.e. the increase in the provision for debt impairment is inconsistent with the under-collection rate (budget may be too high or too low), this is evidence that the budget is unrealistic, not credible or sustainable. Without revision there will be insufficient funds to meet planned expenditure. If this is the case the level of impairment expense and the related debt impairment provision need to be revised consistent with reasonable debt collection expectations. Alternatively, if there is a reason for the inconsistency this should be motivated in the budget document.

   To understand whether there is an inconsistency it can be useful, although overly simplistic, to sum the collection percentage of individual years' and the debt impairment percentage. In the medium term the sum of these percentages should be approximately 100 per cent. A sum that is less than 100 per cent may indicate that there is an insufficient provision for debt impairment; for example: if the budgeted revenue collection rate is assumed to be 90 per cent and the debt impairment expense budget is 5 per cent of billable revenue, then this would be good evidence that the debt impairment expense budget was too low (except in the case where a previously funded provision was too high and is being adjusted). A

total greater than 100 per cent may indicate that either the expense budget is too high or forecast collection levels are unrealistic, although a once-off situation could be justified by a major proven drive to collect arrear debt or that the expense budget is too high.

8. **Capital payments % of capital expenditure**: the purpose of this measure is to mainly understand whether the timing of payments is being taken into consideration when forecasting the cash position. The measure focuses on the capital budget, because expenditure levels for this component of the budget can vary significantly from month to month, as there tends to be monthly consistency for operational budgets. Despite the monthly variability of expenditure on the capital program many municipal budgets have identical amounts in their capital expenditure budgets and cash flow budgets. Applying accrual accounting it is unlikely that capital payments (cash) will equal capital expenditure, as there is a timing difference between the invoice being processed and the payment being made which is most likely approximately one month. There is likely to be a timing difference between the invoices for external works and supplies being processed and the payments actually made in the month following expenditure being incurred (the invoice should have been processed to expenditure and creditors in the month the services or goods were received).

   If the budget year's capital budget is greater than the current year then this growth will normally translate into a percentage less than 100 per cent for capital payments. If the capital budget is less than the current year then it is probable the percentage will be greater than 100 per cent. A municipality may also take into consideration that actual expenditure will be less than the expenditure budget due to efficiency improvements, although a municipality would need to have sound justification for doing so. Percentages that vary greatly from 100 per cent should be reviewed taking into consideration a comparison between the monthly capital expenditure and cash flow budgets of both the current and budget years.

   If the total capital expenditure budget equals the capital assets payments item in the Cash Flow Budget then the budget should be reviewed to confirm. A comparison of the amount of capital expenditure and capital payments of the previous year's June and July would be a guide as to the adjustment necessary to budgeted capital payments, in the absence of more specific information and plans.

9. **Borrowing as a % of capital expenditure (excluding transfers, grants and contributions)**: the purpose of this measurement is to determine the proportion of a municipality's 'own-funded' capital expenditure budget that is being funded from borrowed funds to confirm MFMA compliance. Externally funded expenditure (by transfers/grants and contributions) should be excluded. The borrowing amount used in the calculation is sourced from the cash flow budget, and therefore will exclude any unspent loan funds from a previous year. A percentage greater than 100 per cent could indicate non-compliance with section 46 of the MFMA as it may indicate that new borrowing exceeds capital expenditure; unless the excess is caused by a loan raised in one year for a multi-year capital appropriation (in this case the measurement should be averaged over the period of the multi-year appropriation) unless the loan facility allows for funds to be drawn down as needed.

   Some municipalities have prudential borrowing limits less than the 100 per cent based on sustainability forecasts; e.g. that only 50 per cent of 'own-funded' capital

expenditure will be borrowed and the remainder will be funded from internally generated funds (from operations). The percentage should also be reviewed considering past averages and trends, as a deteriorating trend may also indicate that the proposed borrowing is not sustainable or that insufficient borrowing is being used.

If there is evidence of non-compliance with the MFMA borrowing limitations, that long term borrowing is being used to support short term funding requirements, the amount of budgeted borrowing should be reduced so that the ratio does not exceed 100%. Similarly, if the municipality has prudential borrowing limit policy that limits borrowing to a specified percentage, and the budget is in breach of the Council's own policy, then budget or the policy should be revised.

10. **Transfers/grants revenue as a % of Government transfers/grants available:** the purpose of this measurement is mainly to ensure that all available transfers from other government (national, provincial or district municipalities) have been included in the municipal budget, or that the transfer/grant budgets do not exceed available funds. A percentage less than 100 per cent could indicate that all Division of Revenue Act (DoRA), provincial transfers or district transfers have not been budgeted and should be immediately reviewed. A percentage greater than 100 per cent could indicate that there are unspent transfers being carried forward from the previous financial year, or that an estimate of transfers/grants is unrealistic. It may also indicate that grants are being included in the budget that will never eventuate e.g. the budget includes grants for provincial or national government that have not been budgeted for or donor grants with a low likelihood of success. If the budgeted amounts are unrealistic they should be revised. There may also be a consequential change required to expenditure budgets if grants are changed.

11. **Consumer debtors change (Current and Non-current):** the purpose of these measures is to ascertain whether budgeted reductions in outstanding debtors are realistic. There are 2 measures shown for this factor; the change in current debtors and the change in long term receivables, both from the Budgeted Financial Position. Long term receivables often include 'arrangement debtors' to be paid by the debtor over an extended period of time. There should be consistency between the debt collection rate assumptions and changes in the consumer debtors' balances budgeted for. Debt write-offs will have an impact on the balances.

    A large increase in either measure could indicate that debtors' collection rate is expected to deteriorate. A decrease would indicate that debtors are expected to be reduced. Both situations should be re-examined and checked against recent trends. Special plans to reduce consumer debtors need motivation in the budget document.

    (Also refer to factor 7 - "Debt impairment expense % of billable revenue)

12. **Repairs & maintenance (R&M) expenditure level**: this measure is included within the funding measures criteria because a trend that indicates insufficient funds are being committed to asset repair could also indicate that the overall budget is not credible and/or sustainable in the medium to long term because the revenue budget is not being protected. For example, a degrading electricity or water network will not earn revenue if supply cannot be sustained. Repairs and

maintenance levels should be examined by trend, benchmarking and engineering recommendations. Maintenance backlogs are also a key factor that may have to be funded.

If funding for R&M displays a reducing trend this is evidence that insufficient funds are being committed to asset repair and could also indicate that the overall budget is not credible and/or sustainable in the medium to long term, and therefore the budget should either be reviewed or the funding level substantiated in the budget document.

13. **Asset renewal/rehabilitation expenditure level:** this measure has a similar objective to the R&M measures, but focusing on the credibility of the levels of asset renewal plans. A requirement of the detailed capital budget (since MFMA Circular 28 was issued in December 2005) is to categorise each capital project as a new asset or a renewal/rehabilitation project. The objective is to summarise and understand the proportion of budgets being provided for new assets and also asset sustainability. A declining or low level of renewal funding may indicate that a budget is not credible and/or sustainable and future revenue is not being protected, similar to the justification for 'repairs and maintenance' budgets. High levels of investments in new assets may not be sustainable in the long term.

    This measure also helps understand intergenerational funding, to assess if future generations may have to fund the cost of the current generation's consumption of the asset base. High levels of new assets may not be sustainable in the long term and evidence of an asset management strategy should be provided. The medium term capital budget should maintain an appropriate mix between new assets and renewal of assets, taking changes in technology into consideration.

14. **Financial Performance Budget result (surplus/deficit)**: the purpose of this measure is to assess the overall budget. A 'balanced' budget (revenue = expenditure) may indicate funding compliance, taking into consideration some key aspects of the budget after closer examination (depreciation, asset contributions, capital grants), and evidence of a community paying its way for the resources it plans to consume during the budget period. A deficit may be indicative of property taxes/rates, services tariffs or other fees and charges being too low to cover consumption by the community in the budget period (community may not be 'paying its way' and may be deferring obligations to future generations). A deficit greater than the level of non-cash items such as depreciation may indicate a severe funding shortfall and non-compliance with the MFMA. This may require further review and should be considered in the context of the responses to factors 4 "surplus/deficit excluding depreciation offsets" and 16 "cash flow budget". A surplus is not necessarily indicative of additional funds available to spend, as items such as conditional capital transfers/grants may have an influence and the surplus should be examined with care. A surplus may be required to be at a level to produce sufficient internally generated funds to support a sustainable capital budget. Analysis of the trend of previous years' surplus/deficits is also very relevant, as an improving or deteriorating trend may motivate further or different action.

    Care should be taken to motivate and review contributions to provision items initiated for the first time to comply with GRAP/GAMAP; e.g. landfill rehabilitation. Some items may affect the surplus/deficit, but not have an immediate effect on

cash position. These items and assumptions should be described in budget documentation.

If the Financial Performance Budget result is in 'balance' (revenue equals expenditure) depending on the circumstances of the municipality it may also be evidence of non-compliance. If a 'balanced' result is being supported by a large amount of capital transfers/grants and other asset contributions it is reasonable to conclude that the levels of tax and service revenue are insufficient to be sustainable.

15. **Financial Position Budget**: the purpose of this measure is to also assess the overall budget. Special attention should be give to key items such as Inventory, Current Debtors, Non-current debtors (these 3 items broadly grouped as part of 'working capital'), Borrowing and Community Wealth. Recognition also needs to be given to community growth and its impact on the financial resources of the municipality. If a community is experiencing substantial growth it will likely be causing expanded municipal operations, with increased billing, creditor payments and inventory (refer to individual items for specific discussion). This may require an increased investment in inventory (another working capital item); requiring a cash payment that is not directly reflected in the Financial Performance Budget until the inventory is booked to operational expenses. Efficiency improvements such as 'Just-in-time' may reduce the investment in inventory with a beneficial cash flow impact relative to previous financial years. Debtor collection and creditor payment timing may cause a cash flow shortfall; i.e. if average debtor collection is 45 days and creditor payment and remuneration is 30 days then growth will cause an increased need for cash to cover the gap between payment and collection. Borrowing levels need to be sustainable in that the municipality must be able to prove that it will generate sufficient funds to meet the repayment obligations. An accumulated surplus may indicate that past revenues exceeded expenditure, but unless the surplus is cash-backed it is not available to fund the next medium term budget (refer factor 2 "cash plus investments less application of funds").

16. **Cash Flow Budget**: the purpose of this measure is to also assess the overall budget. The Financial Performance Budget on an accrual basis contains a number of non-cash items and excludes some cash items, so the Cash Flow Budget is crucial to analyse. Positive cash position and cash flows are required to meet obligations as and when they are due. A steadily improving cash flow balance, relative to the growth of the municipality is a good sign of financial health. Declining cash balances may be evidence of financial difficulties. Care needs to be taken that too much focus is not put on the year end balances of cash alone. This could be the most unfavourable cash position time of the financial year, even of the well-managed municipality, as it could be a sign that the all expenditure programs have been finalised prior to the end of the year. An examination of average monthly balances will overcome this deficiency.

    Large cash balances may be a sign of mismanagement or disguising mid-year performance problems. Large cash balances could mean that the capital expenditure program was rushed at year end and contractors/suppliers have not been paid, or the program has not been completed and an adjustment budget will be required.

Poor revenue collection performance for some months during the year may create temporary cash shortfalls.

17. **Other key performance measures**: this measure requires an overall review of the performance indicators presented in Table A8 to ascertain if funding related measures are deteriorating, which may be indicative of a funding issue. Crucial performance measures (current debtors' collection rate, the non-current debtors' collection rate, the capital expenditure rate, borrowing level, own-funds devoted to the capital program and the rate of new and renewal/rehabilitated asset acquisition; also electricity and water losses if these apply) should be analysed to ascertain if they are deteriorating.

    A deteriorating trend could be evidence of a budget that is not credible and sustainable. Trends of these measures can be as crucial as the absolute amount. Deteriorating measurements require investigation and possibly cause a review of the budget.

18. **Summary**: the final step is an overall review to ensure that all measures either meet the specified requirements or have been appropriately motivated in the budget document.

    If an analysis of factors 1 to 17 meet the stated requirements (or after review the budget has been amended by a municipality to do this), then this is good evidence that the budget is compliant with the funding requirements of the MFMA and is therefore probably credible, realistic and sustainable.

The following annexures are included:

Annexure A:	**Budget Format Table A10 - Funding measurement**
Annexure B:	**MFMA Circular 42 (Funding a Municipal budget - 30 March 2007)**

Annexure A: Budget Format Table A10

example Municipality - Funding measurement - Table A10

Description	MFMA section	Ref	Prior Yr -3	Prior Yr -2	Prior Yr -1	Current Year			Medium Term Revenue & Expenditure Framework		
			Audited Outcome	Audited Outcome	Audited Outcome	Original Budget	Adjusted Budget	Full Year Forecast	Budget Year	Budget Year +1	Budget Year +2
Funding measures											
Cash/cash equivalents at the year end - R'000	18(1)b	1									
Cash + investments at the yr end less applications - R'000	18(1)b	2									
Cash year end/monthly employee/supplier payments	18(1)b	3									
Surplus/(Deficit) excluding depreciation offsets: R'000	18(1)	4									
Service charge rev % change - macro target exclusive	18(1)a,(2)	5									
Cash receipts % of Ratepayer & Other revenue	18(1)a,(2)	6									
Debt impairment expense as a % of total billable revenue	18(1)a,(2)	7									
Capital payments % of capital expenditure	18(1)c;19	8									
Borrowing receipts % of capital expenditure (excl. transfers)	18(1)c	9									
Grants % of Govt. legislated/gazetted allocations	18(1)a	10									
Current consumer debtors % change - incr(decr)	18(1)a	11									
Long term receivables % change - incr(decr)	18(1)a	12									
R&M % of Property Plant & Equipment	20(1)(vi)	13									
Asset renewal % of capital budget	20(1)(vi)	14									

References

1. Positive cash balances indicative of minimum compliance - subject to 2

2. Deduct cash and investment applications (defined) from cash balances

3. Indicative of sufficient liquidity to meet average monthly operating payments

4. Indicative of funded operational requirements

5. Indicative of adherence to macro-economic targets (prior to 2003/04 revenue not available for high capacity municipalities and later for other capacity classifications)

6. Realistic average cash collection forecasts as % of annual billed revenue

7. Realistic average increase in debt impairment (doubtful debt) provision

8. Indicative of planned capital expenditure level & cash payment timing

9. Indicative of compliance with borrowing 'only' for the capital budget - should not exceed 100% unless refinancing

10. Substantiation of National/Province allocations included in budget

11. Indicative of realistic current arrear debtor collection targets (prior to 2003/04 revenue not available for high capacity municipalities and later for other capacity classifications)

12. Indicative of realistic long term arrear debtor collection targets (prior to 2003/04 revenue not available for high capacity municipalities and later for other capacity classifications)

13. Indicative of a credible allowance for repairs & maintenance of assets - functioning assets revenue protection

14. Indicative of a credible allowance for asset renewal (requires analysis of asset renewal projects as % of total capital projects - detailed capital plan) - functioning assets revenue protection