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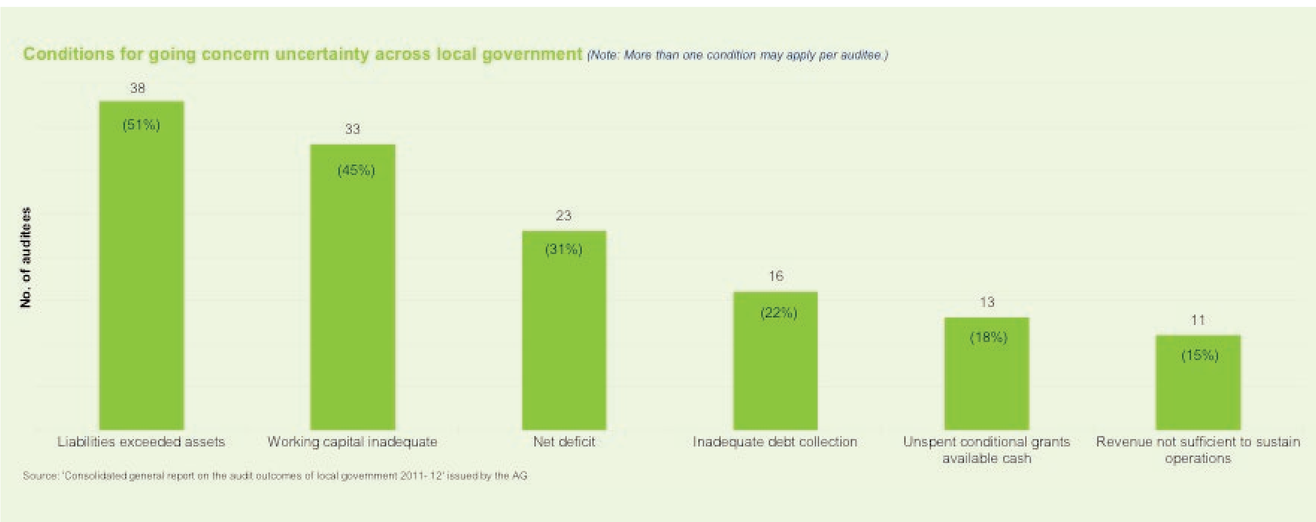
Municipal Clean Audit Efficiency Series
Effective Cash Management

Introduction

The financial performance of the South African local government has recently come under significant scrutiny. This has led to effective cash management becoming an increasingly important aspect of financial management within the municipal sector; especially in the current economy where local government is required to make due with stringent budgets.

How often have we all heard of the phrase, "Cash is King"? Yet we find that ensuring a municipality has sufficient funds when and where they are needed is a constant challenge for financial management teams across local government.

The Auditor-General (AG) recently released its findings on the audit outcomes of local government for the 2011/ 2012 period. The outcomes revealed that out of the 278 municipalities and 60 municipal entities audited (collectively referred to as 'auditees'), 74 either disclosed that a material uncertainty existed with regards to its ability to continue as a going concern, or received a qualified audit report from the AG as such a disclosure was not made. This represents a staggering 23% of local government entities that are currently experiencing going concern problems, largely triggered by the conditions depicted below.



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Getting it right

The most common symptom of the going concern uncertainties identified at the 74 municipalities was a net liability position, which 38 municipalities reported thereby indirectly declaring technical insolvency. Poor working capital management and net cash deficits were also common symptoms exhibited by these municipalities.

These outcomes can be attributed to the fact that municipalities appear to be struggling with effective cash management practices. Whilst the reasons for this may vary from municipality to municipality, they probably include:

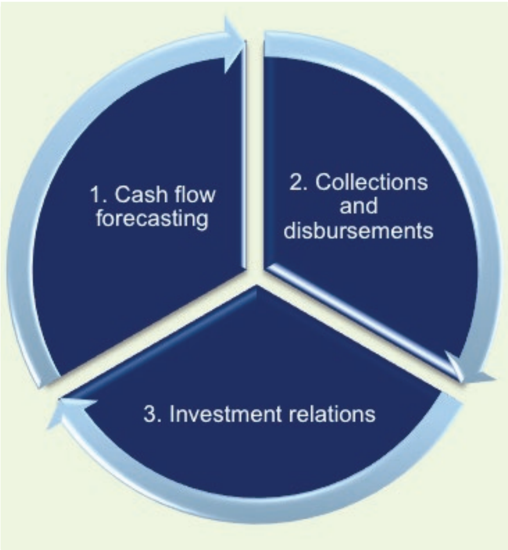
- The lack of a clear, comprehensive policy on cash management and a realistic cash management plan
- Inadequate planning, budgeting and monitoring of operational and capital expenditure
- Inadequate planning, budgeting and monitoring of cash flows
- Inadequate collections and payment processes
- Budgets not being adjusted adequately to compensate for under-collections
- The lack of a well-defined investment strategy resulting in entities failing to invest idle cash in high return, low risk assets, and consequently not being able to generate additional income.

Broader reasons for inadequate cash management across local government entities may include:

- Shortage of financial management skills within the South African public sector
- Deficiency of accountability and oversight from senior officials
- Inappropriate and/or uncommitted leadership
- Inefficient internal controls required to support sound financial management and corporate governance principles.

In our view, effective cash management requires municipal management to take appropriate actions to maintain adequate levels of cash for operational and capital requirements and to invest idle cash thereby, allowing the entity to benefit from the related investment returns. Such practices also benefit communities as incremental investment income can then be used to offset escalating costs without any additional burden being imposed on taxpayers. Furthermore, it ensures that capacity for service delivery to communities is maximised.

In conjunction with sound controls and procedures around documentation, communication, and the monitoring of cash, we consider the following three activities to be vital for an effective cash management practice.



1. Cash flow forecasting

Cash flow forecasting involves estimating future cash receipts and disbursements, for both operational and capital purposes, in order to predict a municipality's cash availability within a given period.

Cash flow forecasts are an important tool that can be used to assess whether a municipality will need to fund temporary cash deficits through short-term borrowing or take other mitigating action such as declaring a moratorium on the municipality's spending. On the contrary, it also provides municipal management with insights as to the amount of cash that will be available for investment on a month to month basis. This allows for a municipality to maximise investment returns whilst ensuring that there is an appropriate cash buffer set aside for unforeseen circumstances.

Cash flow forecasts may cover any period, but generally we find that they are most often compiled on a monthly basis covering a fiscal year.

Cash flow forecasts may cover any period, but generally we find that they are most often compiled on a monthly basis covering a fiscal year. However, for municipalities approaching or those already in financial distress, we recommend the preparation of more granular cash flow forecasts, preferably on a weekly or even daily basis depending on how dire the situation is. This allows for management to have clear visibility of the municipality's cash requirements over the short term.

However, preparing a cash flow forecast is only half the battle won. Regular monitoring of the forecast against actual cash flows is the other half and is equally as important, if not more, in achieving effective cash management. Where significant variances are identified between the forecast and actual cash flows, the forecast should be updated accordingly for the remainder of the forecast period.

Municipal funds are largely driven by grants received and revenue collected from communities for the provision of basic services.

Whilst we find that many municipalities do in fact prepare cash flow forecasts to some extent, it is the monitoring function that often appears to be lacking, thereby leading to the overspending of operational budgets and underspending of capital budgets, as well as other cash related problems. A useful way of overcoming this hurdle is to ensure that the implementation of the cash flow forecast is linked to the performance appraisal of the responsible finance manager (most often the Chief Financial Officer), and that there is appropriate oversight of the responsible finance manager.

2. Collections and disbursements

Collections

Municipal funds are largely driven by grants received and revenue collected from communities for the provision of basic services.

The AG's audit outcomes on local government for 2011/ 2012 revealed that the average collection period across local government in respect of consumer debtors, was 387 days before any impairments (141 days after impairments). National Treasury also highlighted, in a report published earlier this year on the State of Local Government Finances as at June 2012, that 171 municipalities reported debtor levels higher than 30% of its own revenue and that debtors increased by 20% across local government on average. These findings are all indicative of collections by the municipal sector.

Deprived collection practices can place significant strain on a municipality's cash position and may lead to service delivery problems, cross-subsidisation where the entity decides to use funds set aside for capital and other projects to fund day to day operational expenditure, increased borrowings, delayed payments to creditors, and budget deficits being reported by the municipality, amongst other problems. It is therefore imperative that effective debt collection practices are enforced throughout local government.

The following three characteristics are considered to be key in guiding our proposed approach to achieving effective debt collections management:

- Appropriate revenue collection systems that are aligned to the Municipal Systems Act and the revenue management and debt collection policies of the municipality.
- Accurate calculations and timeous reporting of revenue due and outstanding debtors on a monthly basis, thereby enabling appropriate monitoring and oversight of debt collection practices and timely action with regards to impairments or waiver of debts.
- Allocating sufficient staff/ capacity to proactively drive the revenue management and debt collection functions and policies, in order to intensify revenue collections.

Poor creditor and disbursements management practices are often the result of poor planning and budgeting for current and capital expenditure as well as weak cash flow and project management.

Disbursements

The Municipal Finance Management Act (MFMA), section 65, stipulates that the municipal managers must take all reasonable steps to ensure that all money owing by the municipality be paid within 30 days of receiving the relevant invoice or statement, unless prescribed otherwise for certain categories of expenditure; and that the municipality's available working capital is managed effectively and economically. This implies that the timing of expenditures of a municipality should be matched with its predicted income flows.

The AG noted that the average creditor payment period was 70 days across municipalities in 2011/ 2012. National Treasury also identified in its report that 62 municipalities reported creditors of more than 75% of their total cash and investments at the end of June 2012. In addition to these municipalities potentially being non-compliant with the MFMA, delayed payments to creditors may lead to supplier relations and hence service delivery being compromised, as well as additional penalties being incurred by the municipality. Poor creditor and disbursements management practices are often the result of poor planning and budgeting for current and capital expenditure as well as weak cash flow and project management.

On average municipalities across South Africa took approximately two months longer to collect consumer debts (after impairments), than to pay creditors during the 2011/ 2012 fiscal year. Ideally, a municipality's debt collection period should be less than its creditor payment period to ensure that there are adequate cash reserves on hand and that the municipality does not need to rely on external borrowings or overdraft facilities to sustain operations. In our view, there are at least three key priorities to address for effective cash disbursements management:

- The implementation of appropriate creditor payment or disbursement systems that are aligned to the Municipal Systems Act and the disbursement policies of the municipality;
- Accurate calculations and timeous reporting of amounts due to creditors on a monthly basis thereby ensuring that the municipality takes advantage of all applicable discounts, that payments are held until they are due, as well as allowing for adequate monitoring and oversight by the Chief Financial Officer and Municipal Managers of all cash disbursements; and
- Ensuring that the liquidity requirements of the municipality are met (i.e. it is generally accepted that a prudent level of cash coverage is three months of the municipality's average operational expenditure).

3. Investments

Municipalities have a responsibility to solicit banking services from financial institutions that will provide timely, efficient and effective services. As municipalities have limited ability to generate revenues, the investment function has become an increasingly important activity for municipalities. It requires that all cash that is not needed for immediate day to day operations, be invested in order to maximise incremental income for the respective municipality. However, public funds need to be invested with great care as municipalities are accountable to the respective communities in this regard.

An effective investment policy should be aimed at gaining the highest possible return, without undue risk, during periods when surplus cash is not needed.

In our view, characteristics of an effective investment policy include amongst others:

- A prudent set of basic procedures to meet investment objectives
- An appropriate decision-making hierarchy for authority of investment decisions
- Prohibiting the investment of funds for speculative purposes
- Safeguarding of investment assets
- Adequate internal controls and proper accounting records of investments
- Accurate reporting and evaluation of investment results
- Transparency and compliance in all investment processes.

Conclusion

Sound cash management practices should be enforced to ensure that a municipality is able to identify the early warning signs of financial distress or better yet, avoid it altogether.

The financial health of local government is highly dependent on the ability of municipalities to earn and collect revenue and make payments in a productive, competent and effective manner, in order to maximise capacity for consistent and sustainable service delivery to communities.

Leadership of local government has to advocate the need for sound cash management practices, including budget, revenue and expenditure management, and monitor the efficiencies and effectiveness of such practices on a regular basis. We believe that this is the key to developing and maintaining an acceptable level of financial health in local government.

Sound cash management practices should be enforced to ensure that a municipality is able to identify the early warning signs of financial distress or better yet, avoid it altogether. Successful budgeting, planning and completion of capital and operational projects will go a long way in promoting acceptable standards of service delivery, thereby building stronger communities and bettering the lives of our citizens.

Contributors

Nisha Dharamlall
Director in Corporate Finance
Tel: +27 (0)11 806 5605
Email: ndharamlall@deloitte.co.za
Cell: +2783 452 2981

Evelyn Moodley
Senior Manager in Corporate Finance
Tel: +27 (0)11 209 6931
Email: emoodley@deloitte.co.za
Cell: +2782 559 6089

Designed and produced by Creative Services at Deloitte, Johannesburg. (806753/jomaris)