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Report on the Consolidated Financial Statements for the Financial Year 1 July 2004 To 30 June 2005

PERFORMANCE OVERVIEW

Below is a brief performance overview comparing the financial results with the financial targets:

Operational Performance	2003/04 Actual %	2004/2005 Actual %	Target %
· Actual operating expenditure to budget	107.1	90.3	99.0
· Actual operating income to budget	110.1	93.2	99.0
· Capital spending to budget	78.8	90.2	90.0
· Personnel costs to income	28.0	28.0	30.0
Liquidity			
· Debtors collection period	179 days	179 days	42 days
· Outstanding debtors to revenue	31.9	33.0	11,5
Financial Structuring			
· Cost coverage ¹	10 months	11 months	6 months

¹ Cost coverage is determined as follows:

Available cash plus investments divided by monthly fixed operating expenditure, such as personnel costs, purchase of power, etc.

1. INTRODUCTION

It is my privilege to present the report on the financial results of the Nelson Mandela Bay Municipality for the financial year ended 30 June 2005. This report will accompany the standardised financial statements to be submitted to the Auditor-General.

It should be noted that the Municipality is serving as a pilot site in National Treasury's Local Government Budgeting and Financial Management Reform Programme. The Municipality, being a pilot site, is required to implement

Generally Accepted Municipal Accounting Practice (GAMAP). Accordingly, the financial statements for the year ended 30 June 2005 have been prepared in the GAMAP format. This represents the third set of financial statements prepared on the GAMAP basis.

The report firstly deals with Capital Expenditure, then the overall Operating Results, the Balance Sheet, and other Reserves and Special Funds. It concludes with a brief summary of the overall results.

1.1 CAPITAL EXPENDITURE AND FINANCING

1.1.1 CAPITAL EXPENDITURE²

Service	Original Budget	Actual Expenditure	Variance with Original Budget {over/(under)}
	R	R	R
Rate and General	333 924 610	227 116 857	(106 807 753)
Electricity	100 801 000	108 954 278	8 153 278
Water	54 468 000	45 515 372	(8 952 628)
Sanitation	67 014 010	61 240 808	(5 773 202)
Refuse	9 956 700	12 633 568	(2 676 868)
	566 164 320	455 460 883	(110 703 437)

Capital expenditure incurred during the 2004/2005 financial year, compared with the original budget, is as follows:

It should be noted that compared to the 2004/2005 Capital Budget as approved by Council, the actual expenditure amounted to 80,4% of the original approved 2004/2005 Capital Budget.

However, compared to the budget, as amended, in the amount of R504 760 340, the percentage spent was 90,2%. The underspending is mainly due to various projects funded from Regional Services Council Levies not being completed as at year-end.

²Capital expenditure is regarded as any expenditure incurred or incidental to the acquisition or improvement of land, buildings, engineering structures and machinery and equipment. This expenditure normally confers a lasting benefit and results in the acquisition of or extension of the life of a fixed asset or long-term work. It includes vehicles, office furniture and equipment, but would exclude minor items that are generally regarded as being expendable even though in some instances their useful lives may extend beyond one year.

The main reasons for variations compared to the original budget in the categories Rate and General, Electricity, Water, Sanitation and Refuse are the following:

1.1.2 Rate and General

R(Million) (over/(under))

No spending was incurred against the following projects, initially earmarked for funding from a possible external loan. As no external loan was raised during the 2004/2005 financial year, no spending occurred.

• Greening of Metro Areas	(10.0)	
• Gateway Beautification	(5.0)	
• Madiba Bay Development Agency	(12.0)	
• Njoli Square Development	(10.0)	
• Ploughing Fields	(10.0)	
• Infrastructure	(10.0)	
• Freedom Statue	(5.0)	
• N2 Development	(3.0)	
• Bayworld	(10.0)	
• Red Location Museum	(5.0)	
• Convention Centre	(15.0)	
• Colchester Development	(10.0)	
• Van Der Kemps Kloof	(4.0)	
• Beach Development	(18.0)	
• Science Centre (UDDI)	(15.0)	(142.0)

In relation to the following projects, additional funding became available after the approval of the original Capital Budget, which accelerated spending.

• Upgrading of existing sports facilities	1.8	
• Upgrading Walmer sports fields	1.0	
• Njoli Road – Ntshekisa Street to Daku Street upgrading	2.7	
• Tarring of gravel roads	6.4	
• Resurfacing of residential roads	5.2	
• Provision of sidewalks and cycle tracks	2.6	
• Stormwater improvements	1.3	
• Central arterial: Caledon to North Street	2.6	
• Upgrading of NU2 Stadium, Motherwell	6.8	
• KwaZakhele Fire Station	2.4	
• New Brighton/KwaZakhele: Bulk stormwater	<u>1.9</u>	<u>34,7</u>
		(107,3)

1.1.3 Electricity

• Electricity Reticulation: Private Township Development		2.3
Increased spending is attributable to an increased demand for electricity reticulation. The relevant costs are recovered from the developers concerned.		
• Peri-Urban Network		2.0
Additional funding became available after the approval of the original Capital Budget.		
• Fairview Redevelopment		2.7
The commencement of the project was delayed in the previous financial year, resulting in spending being accelerated in the 2004/2005 financial year.		
• Deal Party: Bulk Supply		1.0
Additional funding became available after the approval of the original Capital Budget		
		8.0

1.1.4 Water

No spending was incurred against the following projects, as the relevant MIG (Municipal Infrastructure Grant) approvals were not received during the 2004/2005 financial year. It is anticipated that the projects will be approved during the 2005/06 financial year.

• Motherwell North Supply Pipeline	(3.9)
• Joe Slovo Pipeline	(1.3)
• Witteklip: Bulk Water Supply	(1.3)
• Seaview: Bulk Water Supply	(1.1)
• St Alban's: Bulk Water Supply	(1.2)
	(8.8)

1.1.5 Sanitation

No spending was incurred against the following projects, as the relevant MIG (Municipal Infrastructure Grant) approvals were not received during the 2004/2005 financial year. It is anticipated that the projects will be approved during the 2005/06 financial year.

• Motherwell NU 29 and 30: Main Sewers	(1.8)
• Witteklip: Bulk Sewerage	(1.2)
• Seaview: Bulk Sewerage	(1.1)
• St Alban's: Bulk Sewerage	(1.2)
	(5.3)

1.1.6 Refuse

• Rehabilitation of New Brighton Tip Site	2.4
Additional funds became available, which accelerated the project spending.	
	2.4

2. OVERALL OPERATING RESULTS

Total accrued operating expenditure³ amounted to R2 987 434 792, whilst the total accrued income amounted to R2 919 555 084. This resulted in an excess of accrued operating expenditure over accrued operating income of R67 879 708 for the year, before separately disclosable items of R37 423 005, leaving a net excess of accrued expenditure over accrued income of R30 456 703. After taking into account the transfer from the Non-Distributable Reserves of R158 449 416, the net accrued surplus for the year amounted to R127 992 713.

After comparing actual accrued expenditure and accrued income against the original budget, the results are attributable to the following:

Detailed alongside are the reasons for the more significant variations:

³ Expenditure incurred in the daily operations of the organisation, such as remunerating personnel, transport, repairs and maintenance of equipment, etc.

	R	Variance %	R
Expenditure less than budget:			
Personnel costs	62 473 098	7.1	
General expenses	190 290 906	13.5	
Contributions to capital outlay	720 259	76.7	
Capital charges	2 291 676	5.4	
Repairs and maintenance	4 840 559	2.2	260 616 498
Expenditure greater than budget:			
Purchase of power	(1 596 663)	(0.3)	
Contributions	(26 507 768)	(4.3)	(28 104 431)
Income in excess of Budget:			
Regional Services Council Levies	23 818 537	11.8	
Electricity sales	44 705 727	4.6	
Other income	5 536 082	1.5	
Refuse fees	1 548 529	2.1	
Contributions	35 731 569	7471.2	111 340 444
Income less than Budget:			
Grants and subsidies	(321 352 706)	(49.4)	
Property rates	(2 011 187)	(0.4)	
Water sales	(1 767 214)	(0.8)	
Sewerage fees	(221 163)	(0.1)	(325 352 270)
Separately disclosable items			37 423 005
Reduction in amounts charged-out		(14.5)	(86 379 949)
Shortfall for the year			(R30 456 703)
Less: Transfer from the Non-Distributable Reserves to offset depreciation on assets funded from the AFF			<u>158 449 416</u>
Net accrued surplus for the year			<u>R127 992 713</u>

2.1 Expenditure underspent against budget:

2.1.1 Personnel Costs – R62 473 098

The underspending in personnel costs is mainly due to the non-filling of vacant positions.

2.1.2 General Expenses – R190 290 906

The underspending is mainly due to spending on housing top structures being significantly less than the original budget as a result of a reduction in PHB subsidies.

2.2 Expenditure greater than budget:

2.2.1 Purchase of Power – R1 596 663

The increased expenditure on purchase of power resulted from increased demand, especially from the industrial sector in relation to the utilisation of power to generate steam. The excess expenditure is offset by an increase in the sale of electricity.

2.3 Income in excess of budget:

2.3.1 Regional Services Council Levies – R23 818 537

General improvement in the local economy and the appointment of an external collection agency in March 2003 contributed towards the increased RSC Levies Income.

2.3.2 Sale of electricity – R44 705 727

Electricity sales exceeded the budgeted income largely due to an increase in income derived from steam raising supplies.

2.3.3 Grants and Subsidies – R321 352 706

The decrease is mainly due to PHB subsidies in respect of housing top structures being R315 million less than the original budget.

2.4 Net Operating Results

The net accrued surplus for the year of R127 992 713 is made up as follows:

	R
Net Shortfall for the year	67 879 708
Less: Separately disclosable items	<u>37 423 005</u>
Net accrued shortfall for the year	30 456 703
Less: Transfer from Non-Distributable Reserves to offset depreciation on assets funded from the AFF	<u>R158 449 416</u>
Net accrued surplus for the year	<u>R127 992 713</u>

The net accrued surplus was appropriated in the following priority order in accordance with Council's Financial Policy:

	R
Surplus at the beginning of the year	89 973 337
Surplus for the year	<u>127 992 713</u>
Surplus available for appropriation	217 966 050
Less: Amount reserved to finance levy funded projects committed as at 30 June 2005 and which will be completed during the current (2005/2006) financial year.	<u>72 298 053</u>
Remaining surplus appropriated	<u>R145 667 997</u>

Appropriated as follows:

	R
Transferred to Leave Pay Provision	10 966 004
Transferred to Gratuity Provision	3 718 962
Transferred to Asset Finance Fund	93 505 456
Transferred to Funds and Reserves in respect of interest earned on the respective investments	33 147 916
Transferred to Provision for Obsolete Inventory	4 329 659

Surplus appropriated

R 145 667 997

After appropriation of the surplus, the level of provisions is considered adequate, except the Post-Retirement Benefits Provision. Council has adopted a strategy to fund the liability in respect of post-retirement benefits over a fifteen-year period at approximately R60 million per annum, i.e. transferring R60 million per annum to the provision. As at year-end, the unfunded liability amounted to R603.4 million.

2.5 OPERATING EXPENDITURE

The analysis of Council's operating expenditure is as follows:

Expenditure	R	% of Gross Expenditure
Personnel costs	817 512 342	23.4
General expenses	1 215 967 884	34.8
Purchase of power	563 862 023	16.1
Repairs and maintenance	218 204 041	6.2
Capital charges	39 821 094	1.1
Contributions to capital outlay	218 271	
Contributions	<u>640 671 918</u>	<u>18.4</u>
Gross expenditure	3 496 257 573	100.0
Less: Amounts charged out	<u>508 822 781</u>	
Net expenditure	R2 987 434 792	

Expenditure, such as personnel costs, purchase of power and general expenses in respect of which Council has limited capacity to adjust in the short term, account for approximately 74% of gross operating expenditure. This leaves little scope for variation of other expenditure categories. If Council wishes to increase its capacity for capital spending to improve infrastructure, inter alia, in the previously deprived areas, further decreases will have to be made in overall spending, e.g. personnel, etc.

An analysis of personnel costs by service is as follows:

Service	Original Budget	Actual Expenditure	Variance with Original Budget {Over/(Under)}	
	R	R	R	%
Rate and General	658 572 640	608 353 730	(50 218 910)	(7.6)
Electricity	93 827 630	93 567 401	(260 229)	(0.3)
Market	3 726 850	3 887 401	160 551	4.3
Refuse	29 464 210	28 749 670	(714 540)	(2.4)
Sewerage	44 100 440	38 840 223	(5 260 217)	(11.9)
Water	50 293 670	44 113 917	(6 179 753)	(12.3)
	R879 985 440	R817 512 342	(R62 473 098)	(7.1)

2.6 OPERATING INCOME

The following is a breakdown of Council's operating income represented by the respective income categories:

Income category	R	%
Grants and subsidies	329 018 394	11.3
Rates and Related Income	466 714 723	16.0
Electricity sales	1 026 193 597	35.1
Water sales	231 398 146	7.9
Refuse	74 665 779	2.6
Sewerage	154 350 287	5.3
RSC Levies	226 263 537	7.8
Contributions: other	36 209 829	1.2
Interest on overdue accounts	56 086 988	1.9
Interest on investments	123 752 860	4.2
Other income	194 900 944	6.7
	R2 919 555 084	100,0

Electricity and property rates are the major sources of income, constituting 51% of the income base.

The total income from property rates and related sources amounted to R466 714 723, which was R2 011 187 (0,4%) less than the original budget.

The net operating results are normally reflected in the balance sheet, which will now be discussed.

3. BALANCE SHEET

The balance sheet reflects the financial results and policies of Council at a particular point in time. It is a snapshot at the year-end to determine the asset worth of the organisation and to what extent that worth is encumbered.

3.1 Financial Policies

The objectives of the Financial Policy Review adopted by Council on 25 October 1995 were to establish a Loans Redemption Fund, an adequate Working Capital Reserve and a General Reserve, as prerequisites for attracting external investors. It should be noted that in accordance

with GAMAP, the Working Capital Reserve ceased to exist and therefore the balance was transferred to the Provision for Doubtful Debts with effect from 1 July 2002, whilst maintaining a general reserve is no longer permissible.

There were no major financial policy reviews in the year under review that deviated from this course. The level of the Provision for Doubtful Debts is maintained at 100% of amounts owing by debtors older than 90 days.

The Loans Redemption Fund provides an internal guarantee for the repayment of external loans, while

the Provision for Doubtful Debts must be maintained at an adequate level to recognise the recoverability of outstanding debtors.

3.2 Statutory Funds⁴

Statutory Funds increased by R53,7 million (17.3%) from R309 546 783 to R363 223 645. This increase is mainly attributable to the Asset Financing Fund increasing by R48.3 million.

3.3 Reserves

Reserves decreased by R766 835 (12,42%) from R6 172 339 to R5 405 504.

3.4 Long-term liabilities⁵

Long-term liabilities amounted to R702 624 515, compared to R669 758 460 in the previous financial year and are made up as follows:

	2004/2005	2003/04
	R	
External loans	303 971 526	322 568 674
Provision for ABSA		
Leaseback rental	123 289 031	97 265 587
Provision for		
Post-Retirement Benefits	<u>275 363 958</u>	<u>249 924 199</u>
	R702 624 515	R669 758 460

Long-term liabilities consequently increased by R32,9 million, compared to the 2003/04 financial year, mainly as a result of the Provision for Post-Retirement Benefits increasing by R25,4 million.

⁴Statutory funds consist of the Asset Finance Fund, Loans Redemption Fund, Self-Insurance Fund and Parking Areas Development Fund.

⁵Long-term liabilities consist of mainly external loans repayable over a period of longer than one year after the balance sheet date.

3.5. Property, Plant and Equipment

Property, plant and equipment include infrastructure, buildings, plant and equipment, and amounted to R2 839 186 939, compared to R2 560 137 650 in the 2003/04 financial year. This represents an increase of R279 million or 10,9%.

3.6 Investments

Investments amounted to R1 474 856 568, compared to R1 315 507 007 in the 2003/04 financial year. This represents an increase of R159,3 million or 12,11%.

The total amount invested, however, contains certain monies earmarked for specific purposes as indicated below, over which Council has limited discretion. The net monies available to Council are as follows:

	2004/2005 R	2003/04 R
Investments	1 474 856 568	1 315 507 007
Less: Monies earmarked for specific purposes:	930 472 194	900 019 955
Reserves	5 405 504	6 172 339
Housing Funds	74 923 943	74 153 220
Trust Funds	6 406 682	5 946 850
Asset Financing Fund	228 489 429	180 154 889
Repayment of External Loans	17 757 265	15 558 077
Unutilised Capital Receipts	84 444 514	96 646 835
Insurance Fund	59 810 273	55 238 674
Operating NDRs ⁶	311 712 112	312 979 316
Consumer Deposits	69 224 419	63 196 418
Unspent RSC Levies Income	72 298 053	89 973 337
Net amount available to Council to finance Capital expenditure	R544 384 374	R415 487 052

From the above, it can be concluded that R544 384 374 was available as at 30 June 2005 for internal financing of future capital budgets. According to the 2005/2006 Capital Budget infrastructure expenditure in the amount of R256,6 million is earmarked to be financed from internal sources. It should be noted that if the continued escalation in debtors is not arrested, the available amount might be depleted by the need to finance working capital requirements.

⁶Operating Non-Distributable Reserves (NDRs) have been established into which receipts must be deposited in respect of government grants, subsidies and contributions from the public to finance items of an operating nature.

3.7 Debtors

Debtors amounted to R963 571 283 before deduction of the Provision for Doubtful Debts of R510 349 046.

The increase in debtors threatens the future financial sustainability of the Municipality and is unacceptable for the following main reasons:

- It diminishes the ability to spend on infrastructure development desperately needed for anticipated economic growth and the eradication of service backlogs in underdeveloped areas.
- It negatively affects Council's credit rating and ability to raise loans on competitive terms.
- It makes it impossible to budget for growth.
- It affects tariffs negatively and requires higher than inflation increases. Council may lose its competitive advantage as an investment destination over other centres.
- It frustrates the strategic plan of Council in various ways and results in premature reductions in service levels.
- It leads to reductions in expenditure on much needed maintenance of assets.

The inability to collect outstanding debts timeously is reflected in the debtors' collection period. The situation is as follows:

3.7.1 Average Debtors' Collection Period for Electricity, Water, Refuse, Sewerage and Property Rates

Debtors	960 462 908
Tariff Income and Rates	1 953 322 532
Number of Days	179
Target	42

The following calculation illustrates the amount unnecessarily tied up in debtors as at 30 June 2005:

$$179 - 42 \text{ (days)} \\ \text{-----} \times R960 462 908 = R735 102 896 \\ 179 \text{ (days)}$$

If the debtor's turnover ratio could be reduced to 42 days, an amount of R735 million will become available, which could be used for service delivery, infrastructure development and supporting more affordable tariffs, all of

which will contribute towards making the Nelson Mandela Bay Municipality more attractive as an investment destination.

3.8 Creditors

Creditors amounted to R436 696 817, compared to R371 259 607 in the previous financial year. It should be noted that creditors are paid regularly

3.9 Provisions

Provisions amounted to R84 911 158, compared to R127 802 368 in the previous financial year, and included the following:

	2004/2005 R	2003/04 R
Leave Pay Provision	64 911 158	66 755 798
Gratuity Provision	20 000 000	26 116 775
Retrenchment costs	-	34 929 795
	<u>R84 911 158</u>	<u>R127 802 368</u>

4. NON-DISTRIBUTABLE RESERVES (NDRs)

Non-Distributable Reserves amounted to R3 244 291 556, compared to R2 977 258 166 in the 2003/04 financial year. In accordance with GAMAP, certain non-distributable reserves had to be established. Upon the purchase of an asset funded from the AFF, an amount equivalent to the cost price of the asset purchased has to be transferred from the AFF to a Non-Distributable Reserve called the AFF NDR. This reserve is equivalent to the remaining depreciable value (book value) of assets purchased out of the AFF.

Furthermore, upon receipt, capital receipts in relation to government grants, subsidies and contributions from the public must be deposited into an NDR Unutilised Capital Receipts. Upon the purchase of an asset funded from the NDR Unutilised Capital Receipts, an amount equivalent to the cost price of the asset has to be transferred from the NDR Unutilised Capital Receipts into another Non-Distributable Reserve, called the NDR Utilised Capital Receipts.

The following NDRs have been established:

	2004/2005 R	2003/04 R
AFF NDR	1 010 778 381	868 555 007
NDR Unutilised Capital Receipts	84 444 514	96 646 835
NDR Utilised Capital Receipts	1 209 320 226	990 981 357
NDR (to provide for future depreciation charges)	628 036 323	708 095 651
Operating NDRs	<u>311 712 112</u>	<u>312 979 316</u>
	<u>R3 244 291 556</u>	<u>R2 977 258 166</u>

It should be noted that an NDR was established to provide for future depreciation charges. With the introduction of GAMAP, depreciation had to be determined for the first time from the date municipal assets were initially put into use. During the determination of depreciation charges, certain "credits" arose, which were transferred to an NDR. This NDR is equivalent to the amount of future depreciation charges still to be written off in respect of assets still in use as at 30 June 2005.

5. SELF-INSURANCE FUND

The Fund balance increased from R55 238 674 to R59 810 273.

Claims expenditure exceeded premium income by R704 946, while interest earnings amounted to R3 866 653 resulting in a surplus of R4 571 599 for the year, which was transferred to the accumulated fund.

The insured value of Council's assets amounted to R2,7 billion. The fund is also re-insured externally to cover major losses.

6. CONTINGENT LIABILITIES

The major contingent liabilities and contractual liabilities reflected as notes to the balance sheet are as follows:

Unfunded Post-Retirement Benefits	603 400 000
Department of Transport	<u>107 000 000</u>
	<u>R710 400 000</u>

7. OVERALL RESULTS AND COMMENTS

The overall results are generally acceptable and on the face of the Balance Sheet, the Municipality is one of a few municipalities in South Africa that is financially sound. If this situation is to be maintained, it is important to maintain sound financial management practices and to, at all times, know which risks threaten financial sustainability and take measures to address such risks.

The present risks are essentially the following:

- Continued non-payment of accounts by debtors.
- Uncertainty regarding the eventual personnel costs of the new organisational structure and negotiations

conducted at national level.

- Non-compliance with sound financial practices.
- Continued neglect of assets and underspending on maintenance and renewal of infrastructure assets.
- Possible acceptance by the Municipality of unfunded mandates.
- Continued growth in currently unfunded liabilities.

It should also be noted that with regard to GAMAP implementation certain issues require further attention, such as the physical verification of all assets listed in the Assets Register.

8. VOTE OF THANKS

The appreciation of all Budget and Treasury staff is extended to all Councillors and Aldermen, especially Councillor Odayar, as Chairperson of the Budget and Treasury Committee, Councillor Jerry, as Deputy Chairperson, and all Councillors serving on that Committee for the support and co-operation during the year.

My thanks also go to the Business Unit and Office Managers and their personnel for their support and consistent efforts to maintain financial discipline.

This report is the culmination of a year's unselfish professional services by all Budget and Treasury personnel, who have, despite limited resources, excelled in their duties to meet objectives. It is my privilege to thank them for such dedication and excellence.

PJ VAN ROOY (B.COM; A.I.M.F.O.)
CHIEF FINANCIAL OFFICER