NEWCASTLE MUNICIPALITY

FINANCIAL ANALYSIS REPORT - 2014

19 December 2014

FINANCIAL ANALYSIS

This analytical review of the Budget and Treasury Office is based on the analysis of financial results as are presented in the Annual Reports of the Municipality for the last three financial years being 2011/12, 2012/13 and 2013/14. These Financial Statements were audited by the Auditor-General.

The following are significant results of our analysis on the Municipality's Financial Performance, Financial Position, Cash Flows & Organisation Environment (Budget and Treasury Office)

Financial Performance

The revenue base of the Municipality increased from R1 420 021 710 in 2012 to R1 456 210 889 in the financial year ended 30 June 2014. This represents a growth of 2.5%. During the same period there was a 2.3% decrease from 2012 to 2013. This decrease was due to an amount of R137 million for doubtful debt adjustment which had been credited to revenue during 2012 which had resulted from prior year errors. This adjustment was a book entry and thus not indicative of the actual revenue earned, during the 2012 period.

The increase in revenue from 2013 to 2014 was 4.9% which was slightly below the inflation rates at that time. This means that the municipality's financial performance was rather fair during the period under review.

Year	Total Revenue (R)	% Increase/(decrease)
2014	1 456 210 889	4.9
2013	1 388 741 798	-2.3
2012	1 420 021 710	8

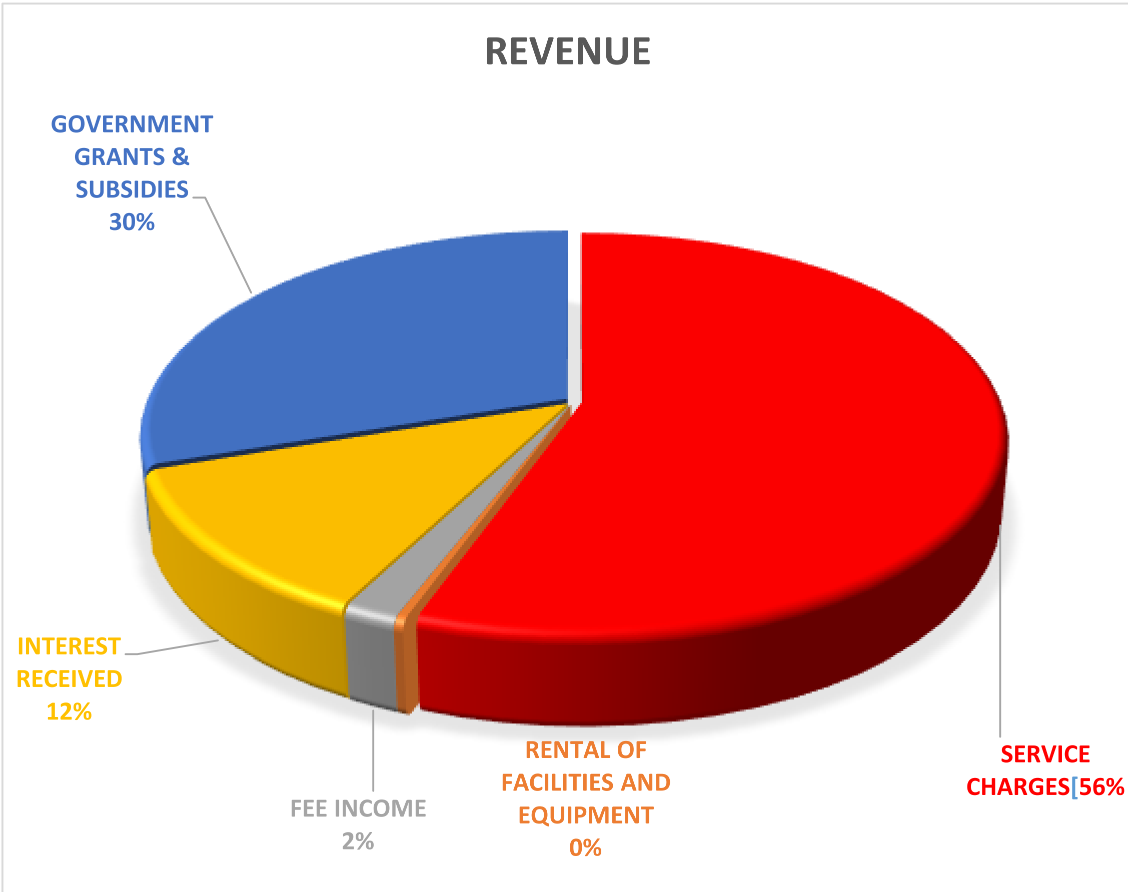
From the table below, the municipality generates more than half its total revenue base from service charges, which is 55.49%. The other significant sources of revenue are Property Rates 12.19%, and Government grants and Subsidies 30.22%.

The percentage contributions of various income sources to total income have remained constant in the years under consideration.

In the Analysis below, the focus is on the material revenue contributing elements in order to analyse their behaviour. In total these contributed R1 439 186 094 which is 99.% to the Municipality's total revenue of R1 456 210 889 in 2014.

Line item	% Contribution 2013	2014
Property Rates	12.19%	175 478 677.00
Service Charges	55.49%	798 616 634.00
Rental of facilities and equipment	0.32%	4 639 974.00
Interest earned	1.77%	25 518 310.00
Governments Grants & Subsidies	30.22%	434 932 499.00
Total Revenue	**99%**	**1 439 186 094.00**
Percentage Increase		**4.9%**
Contributions by material revenue elements		**1 439 186 094.00**
%Contributions by material revenue elements		**99%**

The following graph depicts a contribution of major revenues elements:

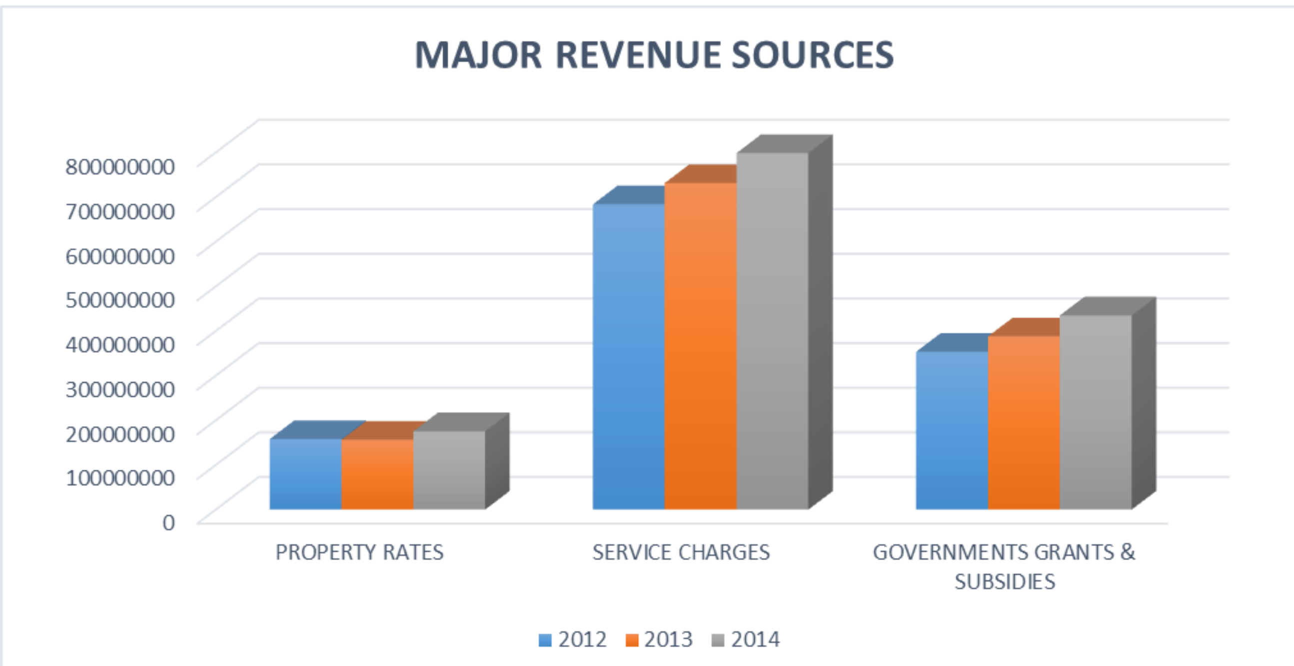


The table below reflects the movement in these revenue streams in the period under consideration. The pattern has, indeed, been erratic and therefore very little conclusions can be reached at this stage. There could be cut-off or allocation issues in the presented numbers. The exercise has not, at this stage, zoomed into an in-depth analysis.

The following tables depict movements of major revenue sources:

Line Item	2012 (R)	2013 (R)	2014 (R)
Property Rates	157 893 000	156 249 490	175 478 677
Service Charges	683 860 407	731 455 268	798 616 634
Governments Grants & Subsidies	353 567 491	387 955 623	434 932 499

The following is a graphical presentation of the patterns of movements of these elements.



Expenditure

The total expenditure of the Municipality has increased by 32.45% from R1 073 168 148 in 2012 to R1 421 506 498 in 2014.

As evident from the table below, moreover, the trends in increases of expenditure far outweigh those in revenue indicating that, at face value, the Municipality has to introduce cost cutting measures. Whereas it is understood that the sharp increase of expenditure increase is caused by the accelerated service delivery to the poor and needy communities there must be an emphasis to conduct business in an efficient manner.

Year	Total Expenses (R)	% increase/(decrease)
2014	1 421 506 498	-8.98%
2013	1 561 782 445	40.53%
2012	1 073 168 148	

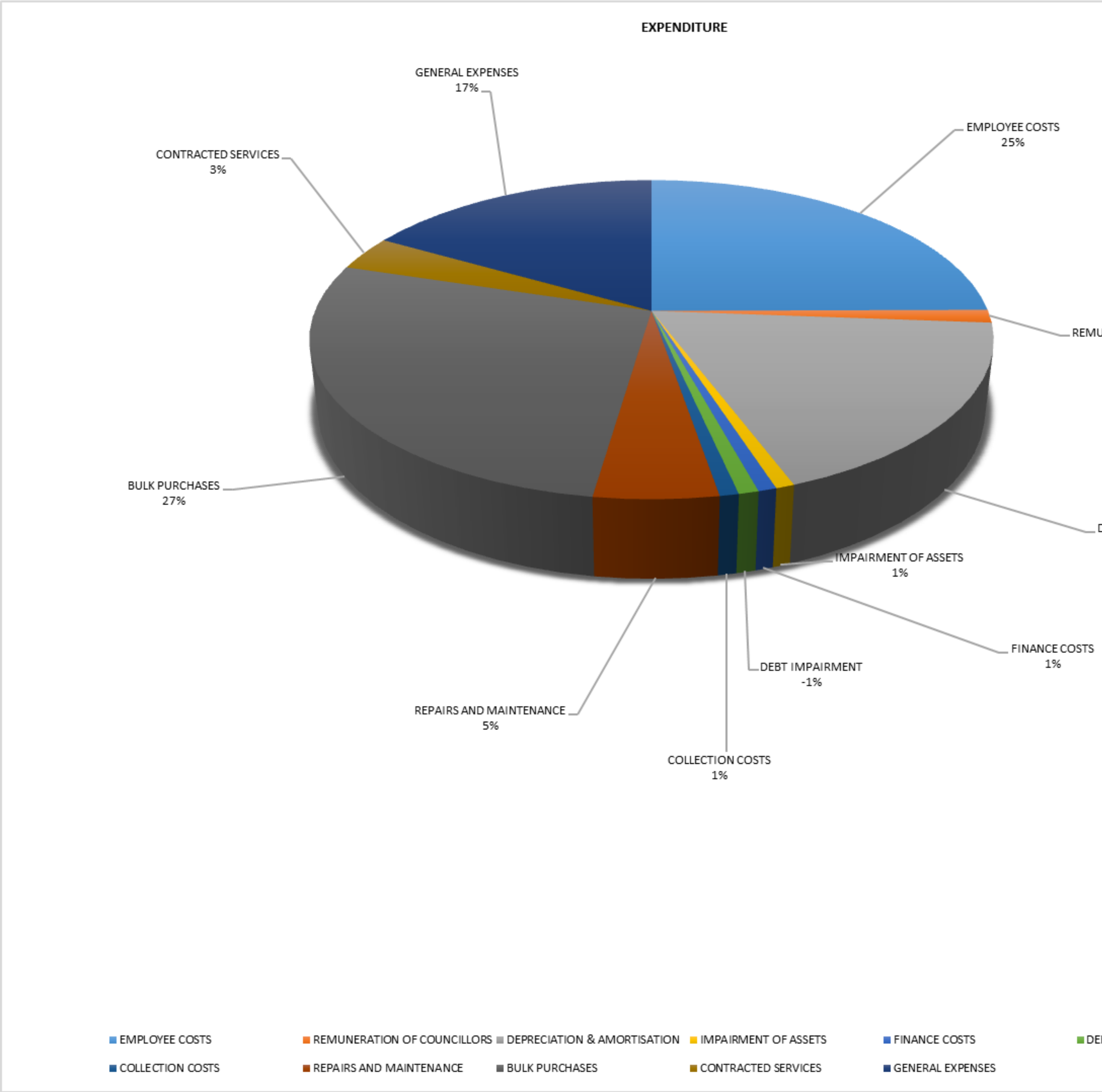
Below is a table of the proportionate contributions of each expenditure element to total expenses. The major expenditure drivers for the municipality are the following:

- Bulk purchases
- Employee related costs
- General expenses
- Share of Losses in Associate
- Depreciation, amortisation and impairments.

The table below depicts contribution of major expenditure items to total expenditure:

Line item	% Contribution 2014	2014
Employee related Costs	25.3	353 488 528.00
Remuneration of Councillors	1.3	18 190 799.00
Bad Debts	0.8	11 177 793.00
Collection Costs	0.77	10 597 688.00
Depreciation	18.4	252 321 047.00
Impairment	0.8	11 177 793.00
Repairs & Maintenance	5.1	68 790 647.00
Finance cost	0.7	11 325 408.00
Bulk Purchases	28	435 608 308.00
Contracted Services	3.6	48 648 945.00
General Expenses	17	223 243 393.00
Total Expenditure	**100.00**	**1 421 506 498.00**

The graph below further illustrates contribution of the major expenditure elements to total expenditure of the municipality:



The focus is on the major expense elements, i.e. employee costs, bulk purchases, General Expenses, share of losses on an associate and depreciation, amortization.

The municipality's employee related costs is 24% of total operational expenditure. This percentage is significantly lower than the prescribed threshold of 35% determined by the National Treasury. Conversely it needs to be mentioned that critical vacant positions need to be filled in order to ensure adequate service delivery.

The following table depicts movements of major expenditure drivers:

Item	**2014 (R)**	**2013 (R)**	**2012 (R)**
Employee related Costs	353 488 528	254 085 135	230 600 985
Depreciation	252 321 047	260 083 473	219 845 295
Bulk Purchases	435 608 308	383 643 252	349 411 144
General Expenses	223 243 393	163 300 934	152 481 330
Total Expenditure	**1 264 661 276**	**1 061 112 794**	**952 338 754**

During the same period our analysis of General Expenses showed an increase of 46.40% from 2012 to 2014. This is mainly due to the growth that the Municipality experienced over the past few years which resulted in the expanded operations. However as mentioned above the issue of conducting our business efficiently cannot be over emphasised.

Debt Management

The outstanding Debt of R816 123 112 remains a challenge. This scenario is disconcerting as it may have a negative impact on our liquidity position if not addressed as a matter of extreme urgency. This therefore necessitates the development of a robust and effective revenue collection strategy.

The municipality has developed a 10 point Debt Management Plan to assist the municipality in curbing and collecting outstanding debtors. The plan encapsulates the following important aspects:

- Appointment of field workers;
- Clarify roles and responsibilities of field workers;
- Friendly legal process;

- Outstanding accounts with no queries to be forwarded to the respective consumers for making necessary payment arrangements;
- Investigate the possible use of call centre for debt collection purpose;
- Progress reports on government debtors;
- Progress reports on staff and councillors debt;
- Identify section 21 schools and address collections;
- Identify additional staff requirements for debt management holistically and communicate with COO;
- Options in respect of Debt Management service;
- Investigate use of the service provider for meter reading compared to performing in-house;
- Fast track installation of water meters;
- Monitor accuracy of readings;
- Investigate the use of meter readers to also deliver accounts;
- Develop internal control for quality assurance on the delivery of accounts;
- Investigate E-account option for delivery of accounts;
- Install water restrictors;
- Indigent verification;
- Phased approach for data cleansing;
- Capacitate staff and field workers;
- Develop marketing and communication strategy;
- Incentive scheme – staggered approach to promote culture of payment;

The implementation of the plan is in its early stage and it is hoped that it will yield result once fully implemented.

Net Operational Performance

The Municipality recorded a surplus R208 546 907 in 2012 which was followed by a deficit of R427 210 289 in 2013 and then a surplus of R61 079 817 in 2014. While the ideal situation is to end the financial year with a surplus at all times, the surplus and deficits are never always an indication of the healthy or poor state of municipal affairs. At times deficits are as a result of the noncash items such as depreciation and debt impairment, which have no impact on the Municipality's cash flow. This has been the case with the Municipality.

Financial Position

Assets

The municipality has an investment of over R3 Billion in assets which comprises. It is worth mentioning that investments property amounts of R273,6 million and this is a good indicator as it allows the municipality to have capacity to render service delivery to communities that it serves.

Item	2014	2013	2012
Assets	**3 396 407 917**	**3 325 479 190**	**2 993 115 025**
Property, Plant & Equipment	2 349 860 723	1 638 272 509	1 258 902 328
Cash & cash equivalents	327 907 203	351 863 529	432 172 072
Investment Property	273 695 000	174 448 593	182 768 593
Intangible Asset	1 348 001	913 426	655 699
Investments in Associate	154 822 299	819 008 493	1 004 790 533
Long-Term Receivables	2 904 899	2 791 339	0
Vat	34 801 284	68 070 371	2 320 461
Inventory	12 439 141	6 907 956	7 096 285
Consumer Debtors	522 181 845	325 961 776	398 896 637
Other Debtors	44 354 725	47 141 281	104 704 656

For the sake of clarity we deemed it necessary to unpack these assets as follows:

Property, plant and equipment

Property, plant and equipment are tangible items that:

- are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and
- are expected to be used during more than one reporting period.

The municipality has significantly invested in assets which augur well for service delivery. Assets increased by 86% from 2012 to 2014. Property, Plant and Equipment represents 44% of the capital structure of the municipality.

Cash and cash equivalents

Cash includes cash on hand and cash invested with banks. Cash and cash equivalents are short-term highly liquid investments that are held with registered banking institutions with maturities of three months or less and are subject to an insignificant risk of change in value.

For the purposes of the cash flow statement, cash and cash equivalents comprise cash on hand, deposits held on call with banks and investments in financial instruments, net of bank overdrafts. The municipality experience a decrease of 24% in cash and cash equivalents from 2012 to 2014. This is due to the expanded investment in the capital assets which resulted in the increase of the asset base as mentioned above.

Investment property:

Investment property is Property (land or a building – or part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

- use in the production or supply of goods or services or for administrative purposes, or
- Sale in the ordinary course of operations.

Investment Property represents 5% of the capital structure of the municipality. Most of Investment Property is vacant land which means the municipality has adequate potential to facilitate development, which bode well for our future revenue growth.

Investment in Associate:

Investment in Associate represents our 34% stake in Uthukela Water. The investment decreased from R 448 751 950 in 2012 to R 980 441 833 in 2013. This is mainly due to the fact that the municipality took over the water reticulation function from uThukela Water.

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Liabilities

The liabilities of the Municipality are just in excess of a R721 Million as reflected below. Clearly the Municipality is a going concern with assets in excess of liabilities.

Line Item	2014	2013	2012
Liabilities	**729 516 051**	**520 629 542**	**425 517 786**
Long-Term Liabilities	221 235 119	62 874 875	60 196 100
Non-current provision for landfill site	25 860 274	22 923 190	22 494 322
Non-current provisions: defined benefit plan obligations	93 802 319	106 938 046	77 822 236
Consumer Deposits	10 027 543	9 974 703	9 958 031
Current Provisions	4 425 946	3 437 863	3 586 643
Unspent Conditional Grants and Receipts	44 948 444	104 964 600	78 711 629
Finance Lease Obligation	509 592	191 531	385 534
Current Portion of Long-Term Liabilities	20 979 603	7 992 190	8 253 375
Payables from exchange transaction	307 727 211	201 332 544	164 109 916

For the sake of clarity we deemed it necessary to unpack these liabilities further as follows:

Long-Term Liabilities:

The Long Term Liabilities has increased from R62 868 405 to R221 235 119 which is 251% increase. The increase is due to due to a new loan that was taken in the previous financial year.

Non-Current Provision for Landfill Site:

In terms of the licencing of the landfill refuse site, council will incur rehabilitation costs of R 25,8 million to restore the site at the end of its useful life, estimated to be in 2017 by our engineers. Provision has been made for the net present value of this cost using the average cost of borrowing interest rate.

Consumer Deposits:

Deposits held in lieu of providing municipal services on credit.

Non-Current Provisions: Plan Obligations:

The municipality provides retirement benefits for its employees and councillors. This means if the Retirement Fund should get liquidated, the municipality will be required to fulfil the obligation to retired employees and councillors. The provision is currently stated at R93, 8 million.

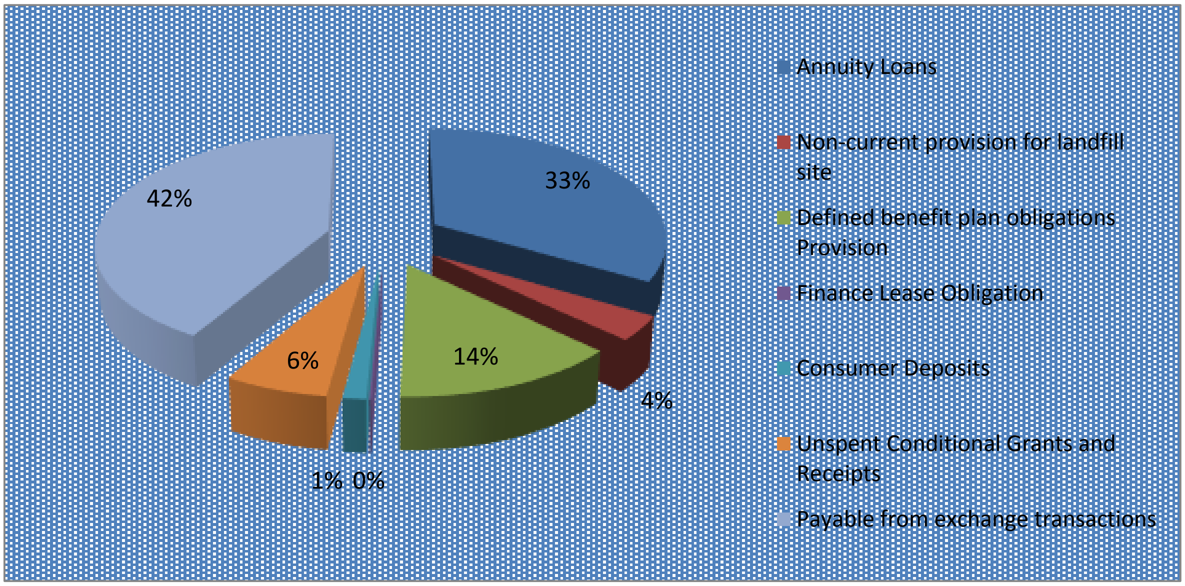
Unspent Conditional Grants:

These are conditional grants from other spheres of government. These amounts represent the obligation of the municipality to comply with the conditions of the grant. If the municipality fails to fulfil the obligations, we will be required repay the money to the National Revenue Fund. The unspent conditional grants are stated at R44, 9 million during 2014.

Trade and other Payables:

Trade creditors, staff leave accrual and payments received in advance which represent amounts invoiced or received by the Municipality where services still have to be rendered. These are obligations which the Municipality will be required to fulfil in the future. The Trade and Other Payables are stated at R307,7 million in 2014.

The proportionate share of individual liabilities to total liabilities is as per the diagram below:



Financial Ratios

The municipality can utilize financial ratios to aid in managing their cash position as well as alert them to the possibility of financial difficulties. Calculating the ratios are not enough. The municipality needs to also consider the trends and patterns over the various financial periods and thus ascertain a better understanding of their cash position.

Solvency Ratio

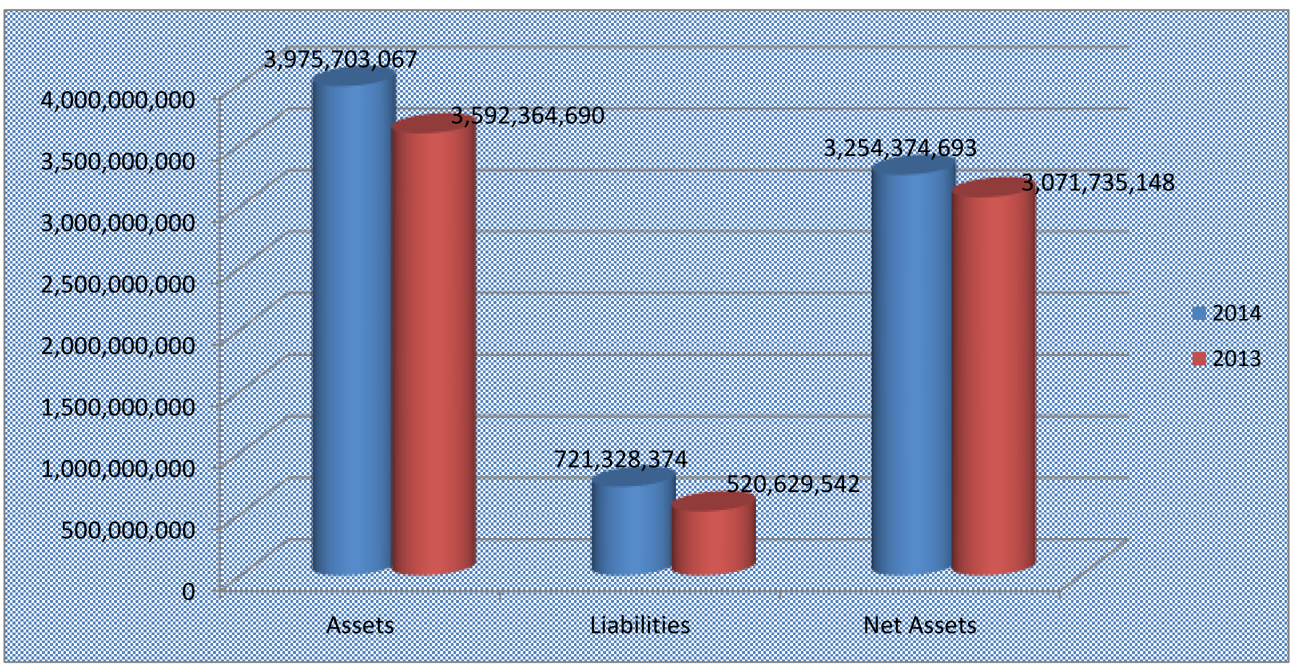
The entity remains solvent with total assets in excess of total liabilities. This is a comforting scenario, as the municipality continues to invest in assets. During the year under review an amount of R245, 9 million was invested in assets. As outlined in the table below, the solvency position (ratio of assets to liabilities) of the municipality has systematically improved from 7.41 in 2010 to 10.90 in 2011 and decline to 8.55 in 2012 and further to 6.83 in 2013. The decline in the solvency ratio is a result of increase in unspent conditional grants of R46 million and defined benefit obligation of R29 million.

If we consider our future outlook, we expect our solvency ratio to decline significantly due to the fact we budgeted to fund our infrastructure with a long term loan amounting to R165 million, which will further put strain in our financial position.

The table below illustrates our solvency situation for the 4 years being analysed:

Item	2014	2013	2012
Assets	3 724 315 120	3 437 022 178	3 347 547 607
Liabilities	729 516 051	520 629 542	425 517 786
Net Assets	**2 994 799 069**	**2 916 392 636**	**2 922 029 821**
Ratio	**5.11**	**6.60**	**7.87**

The graph below illustrates our solvency ratio analysis:



Liquidity Ratios

As evident from the table below, the capacity of the Municipality to fulfil its short term obligations is good. However it is of great concern that although our liquidity position decreased from 7.87 in 2012 to 6.90 in 2013, it has further declined to 5.41 in 2014. This decline is as a result of decrease of R23, 9 million in cash and cash equivalents, which is attributed to construction Civic Centre office building which is funded from internal reserves up to end of 2013/14.

Net Cash Position (Net of Unspent Conditional Grants)

(Cash and Cash Equivalent – Unspent Conditional Grants)

(R327 907 203 – R44 948 444)

Net Cash Position R282 958 759

Conditional Grants are provided to municipalities for a specific purpose and cannot be used for the general operations of the municipality. This ratio identifies whether the municipality has sufficient funds to ensure the cash backing of Unspent Conditional Grants.

Net Cash Position (Net of Unspent Conditional Grants and Reserves)

(Cash and Cash Equivalent – Unspent Conditional Grants – Self Insurance Reserve - Housing Development Fund)

(R327 907 203 – R44 948 444 – R7 095 715 – R27 802 096)

Liquidity Ratios

Item	2014 (R)	2013 (R)	2012 (R)
Current Assets	932 604 120	801 587 818	897 622 338
Current Liabilities	381 488 275	327 893 431	264 807 127
Ratio	**2.45**	**2.45**	**3.39**

The graph below further illustrates our liquidity situation: