



Accounting Standards Board

***RESEARCH PAPER ON  
ACCOUNTING FOR CITY IMPROVEMENT  
DISTRICTS***

## **WHAT ARE CITY IMPROVEMENT DISTRICTS (CIDs)?**

Many City Improvement Districts (CIDs) have been formed in recent years as a local business response to declining municipal budgets and services. CIDs are defined geographic areas in which the majority of property owners determine and agree to fund supplementary and complementary services in addition to those normally provided by a municipality to maintain and manage the public environment at a superior level and thus maintaining or increasing their investment. These supplementary services might include safety and security patrol officers, pavement cleaning, litter collection, maintenance of public spaces, removal of illegal posters etc. The type and the scope of services that are delivered by the CID are based on the needs of the area and the property owners within the area, which can result in improved sales, rents and increased property values.

In some provinces, CIDs are known as Urban Improvement Precincts (UIPs). The objectives, functions and management of UIPs are similar to CIDs.

Once an improvement district is legislated, the cost of providing additional services is borne by the property owners through the payment of a CID levy that will be used to enhance the physical and social environment of the area. The levy, which is a statutory obligation, is mandatory and is based on the land value of the individual stands. Unlike rates, funds contributed by the property owners may only be spent in the area in which they are collected. The municipality remains responsible for providing normal services to a pre-agreed level.

## **WHY ARE CIDs ESTABLISHED?**

One of the biggest reasons for establishing CIDs is that all the issues that may negatively impact on the area, are investigated and dealt with on an integrated basis. This will enhance the safety, cleanliness and economic vitality of the environment, and will strengthen investor confidence and competitiveness within the region.

The effectiveness of the improvement district is constantly measurable. The management body that is established to manage and control the implementation of the CID plan will be able to measure the success of the initiative. As the custodian of the area, the management body through the established CID is aware and can positively comment on any new developments or interventions that will impact on the area in which the CID is operation.

The CID will have effective working relationships with appropriate bodies or associations, including the council of the appropriate municipality. This close relationship with the municipality's council will further improve the area, as the CID is able to put forward ideas and new initiatives.

## **FORMATION AND OPERATION OF CIDs**

Owners of rateable properties located within a geographical area of a municipality may apply to the council of that municipality to approve the establishment of a CID. The applicant(s) should identify and consult all property

owners and major tenants within the defined geographical area on the proposed intervention. A vote in support of the establishment of the CID has to occur and a pre-determined majority, set in terms of the specific legislation or by-law established within the province, must be achieved in order to establish an improvement district legally. However, in some instances the municipality may approve the CID without the vote support, as was the case in some of the CIDs established in Gauteng.

Once the council of the municipality has approved the establishment of the CID, every property owner within the geographical area needs to be informed about the establishment of the CID. Whilst the application to the council's municipality to establish a CID may be made by 25% of the property owners within the geographical area, final approval will not be considered by the municipality's council unless more than 50% of relevant property owners are in agreement with the establishment of the CID.

The council of the municipality is also responsible for the approval of the CID plan, and any amendments to such a plan when council considers it necessary in the public interest.

Once the CID is legally constituted, the CID authorises the council to levy an additional tax on improvement district members, who are required to pay this levy as they have to pay rates. The council collects the levy on behalf of the CID and pays the money received directly over to the CID, without deduction or without giving agency status to an approved agency to collect levies on its behalf.

The CID plan may only be implemented after a management body has been established for the purpose of managing and controlling the CID within the terms of the original CID business plan.

The council of the municipality is required to monitor the compliance by the management body with the applicable legislation or by-law setting out the functions and responsibilities of the CID and the management body. The council must also monitor the management body's compliance with the guidelines and policies issued by the council in respect of the established CIDs within its geographical area.

The management body must be a company incorporated in accordance with the provisions of section 21 of the Companies Act, Act No. 61 of 1973. Owners of the rateable property and tenants within the boundaries of the CID shall be entitled to become members of the CID, provided that the votes of the members are weighted in proportion to the levy payable by them. The weighting awarded to any one member may not exceed one third of the total number of votes that may be cast.

Each CID has its own board of directors elected from the members of the CID. The municipality's council normally nominates a representative to attend and participate in the meetings of the management body. The municipal representative does not have any voting power at these meetings.

The CID is normally established for an initial period of three years, but its life can continue indefinitely unless members move for material changes to the original business plan. Council may dissolve a CID in the case of insolvency of the management body or on written application signed by the majority of owners of rateable property within the geographical boundaries of the CID. Upon the winding up of the management body, the assets remaining after satisfying its creditors and liabilities are transferred to the municipality concerned to be used by the Council to provide additional municipal services in accordance with the CID plan for such area.

## **ACCOUNTING PRINCIPLES IN STANDARDS OF GAMAP**

### **Applying the principles in GAMAP 6 to CIDs**

#### ***Introduction***

The Standard of GAMAP on *Consolidated Financial Statements and Accounting for Controlled Entities* (GAMAP 6) requires a controlling entity, i.e. an entity with one or more controlled entities, to prepare consolidated financial statements and include all controlled entities in such a consolidation.

#### ***What is control?***

To determine whether one entity controls another entity for financial reporting purposes, consideration needs to be given to the nature of the relationship between the two entities and the particular circumstances of each case. Judgement needs to be applied to determine whether the definition of control in GAMAP 6 has been met under each circumstance.

*Control* is defined as the power to govern the financial and operating policies of another entity. This definition does not provide any quantitative measures as indicators that control exists, but requires that the two elements of the definition of control, i.e. the power element (the power to govern the financial and operating policies of another entity) and the benefit element (which represents the ability of the controlling entity to benefit from the activities of the other entity), need to be considered to determine whether consolidated financial statements need to be prepared.

In order for this definition to apply to a municipality, the municipality must control the decision making process and be able to benefit from the activities of the other entity but not necessarily manage the day-to-day operations of that entity. The municipality may not always obtain financial benefits from the other entity but may benefit from its ability to direct the other entity to work with it in order to achieve certain objectives.

#### ***Control for financial reporting purposes***

Control stems from the municipality's power to govern the financial and operating policies of another entity. For control to exist, the municipality is not necessarily required to hold a majority shareholding or other equity interest in the other entity.

The power to control must be presently exercisable, which means that the municipality must already have had this power conferred upon it by legislation or some formal agreement.

GAMAP 6 provides guidance to assist municipalities in determining whether control, and specifically the power and the benefit elements exist for financial reporting purposes.

#### *Power element*

The following are indicators that the *power* element may be present in a relationship between a municipality and another entity:

- The municipality has ownership of the majority voting interest (more than 50%) in the other entity.
- The municipality has the power, either granted by or exercised within existing legislation, to appoint or remove the majority of the members of the board of directors or governing body of the other entity.
- The municipality has the power to cast, or regulate the casting of, the majority of the votes (more than 50%) that are likely to be cast at a general meeting of the other entity.
- The municipality has the ability to veto operating and capital budgets of the other entity.
- The municipality can veto, overrule, or modify decisions of the council, board of directors or equivalent governing body of the other entity.
- The municipality has the ability to approve the hiring, reassignment and removal of key personnel of the other entity.
- The municipality has the ability to establish or amend the mandate of the other entity.
- The municipality has a golden share, i.e. a class of share that entitles the municipality to specified powers or rights generally exceeding those normally associated with the municipality's ownership interest or representation on the council, board of directors or equivalent governing body in the other entity, that confers rights to govern the financial and operating policies of that other entity.

#### *Benefit element*

The following are indicators that the *benefit* element may be present in a relationship between a municipality and another entity:

- The municipality has the power to dissolve the other entity and obtain a significant level of the residual economic benefits or bear significant obligations.
- The municipality has the power to extract distributions of assets from the other entity, and/or may be liable for certain obligations of the other entity

- The municipality holds direct or indirect title to the net assets of the other entity with an ongoing right to access these.
- The municipality has the right to a significant level of the net assets of the other entity in the event of liquidation or in a distribution other than liquidation.
- The municipality has the ability to direct the other entity to co-operate with it in achieving its objectives.
- The municipality is exposed to the residual liabilities of the other entity.

The two elements of control both need to be present, directly or indirectly, to constitute that control exists between the municipality and another entity for financial reporting purposes.

### **Application of GAMAP 6**

#### *The power element*

CIDs are required to have a board of directors, which are elected from the members of the CID. The municipality's council is allowed to nominate a representative to attend and participate in the meetings of the management body, but the municipal representative does not have any voting power at these meetings. The municipality can therefore never have the majority voting interest or the power to cast or regulate the casting of the majority vote at a general meeting of the CID.

Even though the municipality's council is responsible to approve the establishment of the CID and the CID business plan, and require amendments to the business plan where it is deemed necessary in the public's or property owners' interests, the municipality merely performs a regulatory function, as opposed to controlling the functions of the CID.

This is further evidenced from the fact that the municipality's council is required to monitor the compliance of the management body against applicable legislation or by-laws in terms of which the CID was established. Council only monitors the management body's compliance with the municipality's issued guidelines and policies applicable to the established CIDs within the specific geographical area, but the council can not direct or influence the functioning of the CID.

#### *The benefit element*

However, the benefit element is evident and applicable in the relationship between the municipality and the CID in that the municipality's council may dissolve a CID in the case of insolvency of the management body or on written application signed by the majority of owners of rateable property within the geographical boundaries of the municipality.

Another indication of the benefit element is the fact that, upon the winding up of the management body, the remaining assets of the CID are transferred to the municipality concerned so that they can be used by the municipality to provide additional municipal services in accordance with the CID's plan for such an area.

The municipality obtains a significant level of the residual economic benefits of the assets, and in some instances bears significant obligations resulting from the original approved CID plan.

The purpose of establishing CIDs is to provide certain additional and complementary services to property owners within a specified geographical area, in addition to the services provided by the municipality. This further supports the benefit element, because the municipality's council has the ability to direct the CID to co-operate with it in achieving its own objectives.

### **Conclusion**

From the definition of control, it is required that both the power element and the benefit element need to be present before the principles in GAMAP 6 are applicable to the relationship between a municipality and a CID. Because only the benefit element could be demonstrated under the current legislative requirements, municipalities cannot apply the principles in GAMAP 6 to account for CIDs.

## **Applying the principles in GAMAP 7 to CIDs**

### ***Introduction***

The Standard of GAMAP on *Accounting for Investments in Associates* (GAMAP 7) requires an investor to have significant influence over the investee, i.e. the municipality must have the power to participate in the financial and operating policy decisions of the CID, but does not have control over those policies.

### ***What is significant influence?***

As with the requirements in GAMAP 6, GAMAP 7 determines that whether an investor has significant influence over the investee is a matter of judgement based on the nature of the relationship between the investor and the investee, and the application of the definition of significant influence.

The existence of significant influence by an investor is usually evidenced in one or more of the following ways:

- (a) Representation on the board of directors or equivalent governing body of the investee.
- (b) Participation in policy-making processes.
- (c) Material transactions between the investor and the investee.
- (d) Interchange of managerial personnel.
- (e) Provision of essential technical information.

### **Application of GAMAP 7**

The legislative requirements establishing a CID allows the municipality's council representation on the board of directors, even though the municipal representative does not have any voting power at these meetings. Furthermore, the municipality does participate in the policy-making process of the CID, as council is responsible to approve the establishment of the CID and the CID

business plan. Council can also require amendments to the business plan where it is deemed necessary in the public's or property owners' interests.

### **Conclusion**

Significant influence is evident in the relationship between the municipality and the CID and the principles in GAMAP 7 could be applied to the accounting for the relationship between a municipality and a CID.

## **Applying the principles in GAMAP 19 to CIDs**

### ***Introduction***

The Standard of GAMAP on *Provisions, Contingent Liabilities and Contingent Assets* requires a municipality to recognise a liability, if the municipality has a present obligation as a result of a past event, and to disclose information about contingent liabilities to enable the users of the financial statements to understand the nature, timing and amount of such liabilities.

Once the CID is legally constituted, the CID might require additional funding as opposed to the tax levy that is received from improvement district members. The required funding can be obtained from various sources, for example financial institutions, the Development Bank of South Africa, etc. If the municipality guarantees the repayment of the funding that was granted to the CID, the municipality could be liable for the repayment of such funding to the extent that the CID is not able to meet its obligation. The municipality might therefore be required to recognise either a liability or a contingent liability as a result of the guarantee provided.

### ***When should the municipality recognise a liability resulting from a guarantee?***

If a municipality guaranteed the repayment of the funding that was granted to the CID, the municipality should recognise a liability in its financial statements when the present obligation arises as a result of a past event, the past event being the guarantee provided to the lender or financial institution. A provision should be recognised to the extent that the timing or amount of the liability is uncertain.

The municipality should however disclose a contingent liability as part of the notes to the financial statements to the extent that the municipality has incurred a possible obligation that arose from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future event not wholly within the control of the municipality, i.e. when the CID is not able to meet its obligation.

### **Conclusion**

Municipalities should consider the principles in GAMAP 19 to determine whether a liability or contingent liability should be recognised and disclosed in the financial statements in instances where the municipality has provided a guarantee to financial institutions relating to the repayment of funds loaned to CIDs when the CID is not able to meet its obligation.

## LEGISLATIVE CONSIDERATIONS

### *Introduction*

Section 122(2) of the Municipal Finance Management Act, Act No. 56 of 2003 (MFMA) requires a municipality that has sole control of a municipal entity, or has effective control, within the meaning of the Municipal Systems Act, of a municipal entity that is a private company also, in addition to preparing annual financial statements, to prepare consolidated financial statements of the municipality and such entity.

Section 122(3) of the MFMA further requires that the municipality must prepare both the annual financial statements and the consolidated financial statements in accordance with generally recognised accounting practice, prescribed in terms of section 91(1)(b) of the Public Finance Management Act, Act No 1 of 1999, as amended.

### ***Does a CID fall within the definition of a municipal entity?***

The Municipal Systems Act, Act No. 44 of 2003, defines a municipal entity as:

- (a) a company, co-operative, trust, fund or any other corporate entity established in terms of any national or provincial legislation and which operates under the ownership control of one of more municipalities and includes, in the case of a company under such ownership control, any subsidiary of that company; or
- (b) a service utility; or
- (c) a multi-jurisdictional service utility.

Established CIDs fall within the definition of a municipal entity as defined in the Municipal Systems Act, as the CID is a company, established in terms of section 21 of the Companies Act, Act No. 61 of 1973. The CID is established in terms of provincial legislation or a specific by-law, and from the previous discussion it was concluded that CIDs operate under the ownership control of specific municipalities.

However, for the requirements of section 122(2) of the MFMA to be met, the CID must be private company. The applicable legislation or by-law that regulates the establishment of CIDs requires that the management body must be a company incorporated in accordance with the provisions of section 21 of the Companies Act, Act No. 61 of 1973.

Even though CIDs fall within the definition of a municipal entity, the requirements of section 122(2) of the MFMA will not be applicable to CIDs, because CIDs are section 21 companies and not private companies as required by the MFMA.

### ***Accounting implications vs legislative requirements***

The requirements of section 122(2) of the MFMA, that requires a municipality that has sole control or effective control of a municipal entity that is a private company to prepare consolidated financial statements, are not applicable CIDs, because CIDs are section 21 companies and not private companies as required by the MFMA.

However, the requirements in the Standards of GAMAP go beyond the legislative requirements of the MFMA and the Municipal Systems Act. Because the requirements of GAMAP 7 regarding significant influence have been met, the municipality is required to prepare consolidated financial statements in terms of section 122(3) of the MFMA.