

# REPORT OF THE AUDITOR-GENERAL TO THE COUNCIL ON THE FINANCIAL STATEMENTS OF THE NELSON MANDELA METROPOLITAN MUNICIPALITY (THE METRO) FOR THE YEAR ENDED 30 JUNE 2005

## 1. Audit Assignment

The financial statements as set out on pages 1 to 42, for the year ended 30 June 2005, have been audited in terms of Section 188(1)(b) of the Constitution of the Republic of South Africa, 1996 (Act No. 108 of 1996), read with Sections 4 and 20 of the Public Audit Act, 2004 (Act No. 25 of 2004) and Section 126 (3) of the Municipal Management Finance Act (Act No. 56 of 2003). These financial statements, the maintenance of effective control measures and compliance with relevant laws and regulations are the responsibility of the Municipal Manager. My responsibility is to express an opinion on these financial statements, based on the audit.

## 2. Nature and Scope

### Financial audit

The audit was conducted in accordance with the Statements of South African Auditing Standards. Those standards require that I plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements,
- Assessing the accounting principles used and significant estimates made by management, and
- Evaluating the overall financial statement presentation.

Furthermore, an audit includes an examination, on a test basis, of evidence supporting compliance in all material

respects with the relevant laws and regulations, which came to my attention and are applicable to financial matters.

The audit was completed in accordance with Auditor-General Directive No. 1 of 2005.

I believe that the audit provides a reasonable basis for my opinion.

The Metro has opted for early implementation of GAMAP. Although the effective dates of application of these Standards of Generally Recognised Accounting Practice (GRAP) and Generally Accepted Municipal Accounting Practice (GAMAP), also referred to in my audit opinion in paragraph 4 below, have not yet been gazetted by the Minister of Finance, they have been recommended for implementation by the Accounting Standards Board and National Treasury.

## 3. Qualification

### 3.1 PROPERTY, PLANT AND EQUIPMENT

#### 3.1.1 Land not valued

Land of an unknown value was not recorded and included in the relevant register of the Metro. This is mainly due to the fact that the land verification process has not yet been completed. The Metro is still not in a position to determine the correct classification of all land owned by the Municipality, and hence inclusion into the fixed asset register or inventory records as appropriate. The

monetary effect on the balance sheet can at this stage not be determined. The likely effect would be an increase to the non-distributable reserves as well as the property, plant and equipment balances.

However, should Council's intention be the resale of the land, the inventory balance would have to be increased prior to the sale (trade) of the land. In this regard, an amount of R9.7 million (2004: R8.8 million) relating to land sales was accounted for as operating income.

#### 3.1.2 Physical verification and valuation and status of the fixed asset register

The existence, completeness and valuation of all fixed assets could not be determined, because the project related to the physical verification and valuation of assets owned by the Metro had not been finalised. This matter was raised in the prior audit report to which Council responded by stating that an Asset Management Unit had been established that would oversee this process and report to the Municipal Manager. The process was projected to be finalised by June 2006.

As a result, the extent to which property, plant and equipment may be over- or understated could not be determined in view of the uncertainty stated above.

### 3.2 LEVY INCOME

The completeness of levy income of R226.2 million could not be verified due to the inherent uncertainties surrounding levy income.

The efficiency and effectiveness of the work conducted by the Council appointed external levy collection agency remains a problem as reported on in the prior year, due to the following:

- (a) The agency did not attend to the identification of non-registered levy payers (they focused mainly on the collection of arrear amounts)
- (b) Our limited sample test revealed that 20% of the businesses sampled were not registered.

### 3.3 LONG-TERM DEBTORS

While conducting our tests on long-term debtors, it was determined that no agreements for state housing loans to public organisations could be provided. Furthermore, from the evidence obtained, these loans were authorized to be written off by the then Member of the Executive Committee: Eastern Cape: Department of Housing, Local Government and Traditional Affairs (the MEC) during 1999.

These amounts should therefore not be included under long term debtors for the year under review. Long-term debtors are therefore overstated by an amount of R13 million.

## 4. Qualified Audit Opinion

In my opinion, except for the effect on the financial statements of the matters referred to in paragraph 3, the financial statements fairly present, in all material respects, the financial position of the Metro as at 30 June 2005 and the results of its operations and cash flows for the year then ended in accordance with prescribed accounting practice.

## 5. Emphasis of Matter

Without further qualifying the audit opinion expressed above, attention is drawn to the following matters:

### 5.1 HOUSING STOCK

As reported on in the prior year, due to stock issues not being captured at the time of the actual transaction and the lack of controls evident over housing stock, the validity,

accuracy and completeness of housing stock could not be verified. The following is the current year audit findings in this regard:

- (a) stores personnel had not performed a year-end stock count for housing stock
- (b) the audit team could not perform a stock count at year-end because stock items could not readily be identified to be counted because of a lack of product codes.

The value of these stock items as per the stock sheets amounted to R16 million as at 29 June 2005. The general ledger provided for audit purposes reflected an eventual balance in respect of housing stock of R2.6 million. Stock related transactions, including stock issues, amounting to R13.4 million (R16m – R2.6m) were processed subsequent to the end of June 2005.

### 5.2 SUPPORTING DOCUMENTATION EXPENDITURE

Various supporting documentation for creditors and expenditure payments could not be provided for audit purposes. As a result, expenditure incurred by the Metro amounting to R37 million was included in the original audit sample, but could not be verified. This matter has been reported on in previous years and the problem of adequate document and record keeping appears to be escalating.

### 5.3 TENDERS - PROCUREMENT POLICY

Details of the following matters were provided to the officials during the course of the audit. Responses remained overdue at the due date of this audit report.

The following matters were noted during the review of tenders on a sample basis:

#### 5.3.1 Non-adherence to the preferential procurement policy

- (a) Tenders were awarded to tenderers who did not score the highest points, and reasonable and justifiable reasons as required by the procurement policy, were not provided or considered by the auditors to be

reasonable and justifiable.

- (b) Certain suppliers had not been checked for clearance before they were awarded contracts, evidenced by the unavailability of these clearance certificates on contract files.
- (c) Tender orders approved by an official who did not have the appropriate authority to do so.
- (d) A tender did not go to the Tender Bid Committee for approval and no Municipal Manager's resolution was obtained. The total value of the tender order amounted to R229 000.

#### 5.3.1 Financial errors

- (a) A sample test revealed an 84% error rate related to cases where the total order cost per the system was not the correct accumulation of all the items in that particular order, inclusive of VAT.
- (b) Unit prices per the quotes were different to unit prices per the order.
- (c) Orders were not made out to suppliers who had won the contract

#### 5.5.3 Control matters

- (a) No evidence could be provided to indicate that the relevant fees were paid for the respective contracts.
- (b) Overall, the record keeping regarding a number of contracts appeared to be weak.

### 5.4 WATER UNACCOUNTED FOR

Water not accounted for as a percentage of water available for distribution, amounted to 24.1% (2003/04: 21.3%). (See Appendix "E" to the financial statements). Distribution losses in excess of 10% are regarded as abnormal, although Council is of the opinion that 15% is abnormal.

The rand value loss with the distribution of water to the Metro amounted to approximately R28.9 million (2003/2004: R18.7 million).

The above indicates that basically one out of every four litres distributed by the Metro is lost (or unaccounted for). This should be seen in the context of water scarcity in

the RSA as a whole, and the periodic consideration of imposing water restrictions on residents and users.

## 5.5 HOUSING CONTRACTS

Contract stipulations were not met in certain instances. These included:

- (a) Projects not completed by the agreed date.
- (b) No penalty charged for late completion.

## 5.6 HUMAN RESOURCES

The following issues were noted for the current year:

- (a) During the period under review, a number of key officials were suspended. These included three Business Unit Managers. In addition, the Municipal Manager himself was suspended in September 2005. Suspensions were not finalised in a timely manner, whilst officials remain in receipt of salaries. This constitutes potential fruitless expenditure.
- (b) Due to poor record keeping, various documentation to state the relevance and legitimacy of a number of newly appointed employees could not be found on files.
- (c) Documentation generated by the Recruitment Committee on the final conclusions or decisions arrived at regarding new appointments were not properly filed.

## 5.7 INTERNAL CONTROL AND CONTROL ENVIRONMENT

### 5.7.1 Control Weaknesses

In terms of Section 62 (1)(c) of the MFMA, the accounting officer of a municipality has to ensure that the municipality has and maintains effective, efficient and transparent systems of financial and risk management and internal control. Deficiencies in internal control measures identified during this and the prior year audit were brought to the attention of management by means of various management letters and follow-up communication.

### 5.7.1.1 A lack of sufficient implemented controls is evidenced by the following:

- (a) Manual records and inventory are not adequately protected.
- (b) Management does not timely address risks identified in the overall risk assessment in all instances.
- (c) Reconciliation and reporting requirements with regards to stock shortages and surpluses are not up to date, as they are not performed on a monthly basis.
- (d) No reconciliation is performed between the physical and theoretical stock held at the various Metro stores on a monthly basis and at year-end.
- (e) Performance contracts only in place up to Office Manager level.
- (f) Delegated responsibility and authority matrix only in place up to office manager level, but not for all levels of employees.

### 5.7.1.2 Implemented controls that have not functioned properly or adhered to at all times are listed below:

- (a) No policies are in place for the maintenance of assets and the valuation/impairment of assets or inventory.
- (b) Segregation of duties does not exist for each transaction type, most notably for journal management system and the fuel stock system.
- (c) Independent checks are not always performed for various accounting and control functions.
- (d) Recommendations from internal audit to improve and modify internal controls are not being adhered to by management in all instances.
- (e) External audit recommendations are not implemented in all instances.
- (f) Audit queries are not always responded to in a timely manner
- (g) Risk assessment was performed a year ago and has not been completely updated.
- (h) Risks are in the process of being addressed, however, only 6 out of the 17 units (11 business units and 6

office managers) have submitted progress reports. This, however, was not done on a consistent basis, as required every second month.

- (i) The monitoring and response to the non-submission of progress reports by the relevant senior official does not have the desired outcome.

### 5.7.2 Potential for fraud

Contained in this report and the relevant management letters are various conditions or events that increase the risk of fraud and error. These include:

- (a) A persistent failure to correct major weaknesses in internal control (re-reported items).
- (b) Significant and prolonged understaffing of business units with the effect that competent, experienced and suitable staff are not always available.
- (c) Pressure exerted on top management, e.g. to meet budgets and other targets required by the IDP.
- (d) A breakdown in control systems in particular as mentioned in this report.
- (e) Corporate governance structures, such as internal audit and the audit committee, that do not function as envisaged.

The following issues also contained in this report is indicative of fraud and error:

- (a) Housing stock shortages as reported in the prior and current year.
- (b) The non-compliance with the preferential procurement policy in certain instances.

### 5.7.3 Internal audit

The staff complement in the Internal Audit Division was not adequate to attend to all the matters as per the internal audit plan with minimal work being performed on the full internal control and accounting systems of the Metro.

The following issues were identified:

- (a) Deviations from the audit plan resulted in all audits planned not being conducted. This is due to the large number of forensic assignments that had to be conducted. Although forensic audits and investigations are included in the scope of the Internal Audit Division, the shortage of staff experienced in

the division has contributed to the fact that minimal work is performed on the various internal control systems of financial cycles that makes up the municipality and performance measures.

- (b) No internal audit training and development programme has been developed to facilitate continuous education of the staff. Training received was not always directly related to the internal audit discipline.

On a positive side, the Internal Audit Division was instrumental in establishing and facilitating communication within the Metro related to the Fraud Prevention Policy, as well as being involved in a number of forensic assignments including:

- (a) Investigation : Alleged theft and sale of scrap metal at the Uitenhage Fire Services.
- (b) Investigation: Alleged issue of fraudulent condemnation certificates and sale of condemned food.
- (c) Investigation: Alleged irregularities in the withdrawal of PE traffic fines and summonses.
- (d) Investigation: Alleged irregularities pertaining to the Human Resources Conference on 13 September 2004.

The outcome of some of these investigations is pending and will be followed up in the next audit.

#### 5.7.4 Audit Committee

The following matters related to the Audit Committee were noted for the period under review:

- (a) Although stated in the charter, performance measures were not considered by the Audit Committee.
- (b) The audit committee has not formally commented on the 2003/04 year proceeds, i.e. the Annual Financial Statements, the regularity audit, as well as the performance measures report submitted by the Auditor-General.
- (c) Council does not periodically evaluate the effectiveness and performance of the Audit Committee.

In addition to the above, it was noted that no performance audit committee had been appointed or that the existing

Audit Committee's terms of reference were amended to include this function as previously reported.

Based on the above, the Committee did not function fully in terms of the requirements as envisaged in Section No. 166 of the MFMA.

### 5.8 PERFORMANCE MEASURES

An audit on the Metro's performance measurement system according to section 46(1) of the Local Government Municipal Systems Act, 2000 (Act No. 32 of 2000) was conducted and is reported on separately.

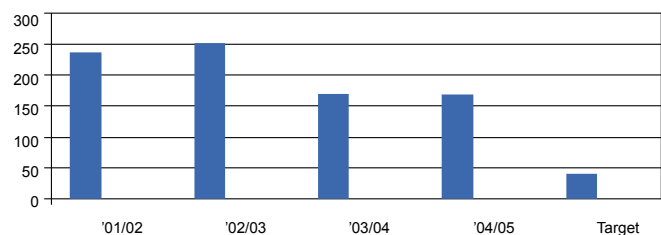
### 5.9 COLLECTION OF OUTSTANDING DEBT

Per note 11 to the annual financial statements, outstanding consumer debtors amounted to R963 million. The council has set a target debtors collection period of 42 days. At 30 June 2005, the service debtors' collection period, as reported in the Business Unit Manager: Budget and Treasury's report to the financial statements, was 179 days.

The debtor's collection periods for the past four years of the metro's existence is noted below.

S96 (b) of the Municipal Systems Act requires that the municipality adopt, maintain and implement and credit control and debt collection policy which is consistent with its rates and tariff policies. A Revenue Management and Customer Care policy is in place. However, in view of the results above, it appears as though the implementation of this policy does not produce the desired results i.e. a reduction in the collection period to the level set by council as a target as disclosed in the metro's financial statements.

#### Debtors Collection Period (in days)



## 5.10 ENVIRONMENTAL, SUSTAINABLE DEVELOPMENT AND OCCUPATIONAL HEALTH AND SAFETY ISSUES

Specific environmental, sustainable development and occupational health and safety issues were audited as part of the regularity audit for the 2004/05 financial year. Metro officials were briefed on the findings on all areas covered.

Notwithstanding the following observations, positive and sincere efforts are being made by the Metro to improve and ensure the sustainability within the Metro's jurisdiction area.

The following issues were identified:

#### 5.10.1 Arlington Landfill Site

A follow-up visit to Arlington Landfill Site was undertaken (was also done in 2004). The focus of the visit was limited to the actual landfill operation and aesthetic issues noted on and around the site.

With due consideration of the 2004 audit findings, the following observations were made:

- (a) A significant degree of scavenging occurs on site under extremely dangerous/hazardous conditions. Members of the community remain on site without authorisation, whilst the mechanical compactor operates within meters from them, constituting serious health and safety risks.
- (b) Security risks to all other legitimate users of the site (caused by members of the community partaking in scavenging).

A significant degree of littering of waste on site and the surroundings was observed, which indicates that the compaction and cover (required on a daily basis) are not sufficient.

#### 5.10.2 Motherwell Canal Discharge Point

The Motherwell Canal Discharge Point was re-visited and the same risks and hazards as previously noted were again evident. The main issue (aesthetic) includes the pollution or discharge of sewage and other solid



waste from Motherwell (canal) into the Swartkops River. Litter and solid waste accumulated at this discharge point, without any barrage or structure to prevent the waste from flowing into the Swartkops River. This sewage and other waste pollution is a main contributor to the downgrading of the Swartkops River and the use thereof.

### 5.10.3 Walmer Township

As noted in the prior year, houses and other structures were erected in the Walmer Township on a decommissioned and unknown landfill site, bounded by the airport and another development area.

### 5.10.4 Involvement of Internal Audit Section

Internal Audit's planned activities do not include the coverage of environmental issues.

## 5.11 CONTINGENT LIABILITY : DEPARTMENT OF TRANSPORT

On 11 February 2004, the Eastern Cape Provincial Department of Transport initiated proceedings in the High Court to contest Council's application to offset vehicle license fees collected on behalf of the department. The vehicle license fees are utilised in settlement of the outstanding arrears owed to Council by the other provincial departments.

The amount in dispute as at 30 June 2005 was approximately R94 million. This matter was disclosed as a contingent liability in the 2004/05 financial statements.

Subsequent to the year-end, the Department has entered into an agreement whereby licenses can be renewed at Post Offices. This arrangement has some financial impact on the Metro and includes reduced revenue and cash flow.

## 5.12 ISSUES RAISED BY THE AUDITOR-GENERAL IN THE AUDIT REPORT

The Council responded and adopted an action plan to address the prior audit report on the Metro's financial statements at its meeting held on 26 May 2005. The planned actions and/or the timeframes in response to the

audit report did not have the desired effect as this audit report contains a significant number of findings that has been reported in prior years.

The MFMA (Section 131(1)) determines that the municipality must address any issues raised in the audit reports and that the mayor must ensure compliance by the municipality.

Compliance with this section of the MFMA will be focused on during the next audit.

## 5.13 PRIOR-YEAR METRO AUDIT REPORT ITEMS

### 5.13.1 Forensic review – Housing

The results of the forensic audit investigations conducted into housing subsidy projects at the request of the Member of the Executive Council (MEC): Local Government and Housing in the 2003/04 are still being reviewed by officials and management and are to be considered by Council. The original date of officials responses was the end of January 2005. At the due date of this audit report, these investigations and Council's final decisions have not yet been made public.

In addition, subsequent to the year-end, the Member of the Executive Committee: MEC: Local Government and Housing has called for a 100% forensic audit on housing to be performed at the metro.

### 5.13.2 Human Resources

Various issues were noted during our audit review of the administration of Human Resources, more specifically the appointment of traffic officers.

A forensic investigation by the Metro's Internal Audit Committee as well as an investigation by an external party at the request of the Municipal Manager, was performed in 2004 regarding the selection and placement process undertaken by the Human Resources Business Unit.

At the due date of this audit report, the matters raised by this audit team had not been responded to, and the results of the investigations had not been finalised by Council.

### 5.13.3 Fruitless Expenditure in the 2001/02 audit report

Council resolved at a meeting dated 19 June 2003 that the Municipal Manager should report on the steps taken to recover fruitless expenditure as set out in the prior-year audit report. The Municipal Manager reported to Council at a meeting held on 4 November 2004, but no resolution was adopted in order to finalise the matter. It should be noted that this matter was reported on in the 2001/02 audit report and by the due date of the audit report on the Metro i.e. 30 November 2005, a final response from the Council had not been received.

A response has subsequently been received and will be dealt with as part of the next audit.

## 5.14 LATENESS OF AUDIT REPORT ON THE METRO'S FINANCIAL STATEMENTS

The audit report on the Metro's financial statements is due within three months of receipt thereof. Financial statements on the Metro were received on 31 August 2005 and therefore the audit report was due on 30 November 2005. The following issues, combined with staffing capacity issues within the local centre, have contributed to the audit report on the Metro's financial statements being completed after the due date.

Apart from those specific cases mentioned in the preceding paragraphs of this report, outstanding information and responses from the Metro as at 30 November 2005 include:

- (a) Deviations from the standards and guidance related to the format and content of the financial statements were conveyed to the municipal officials on 9 September 2005.
- (b) Responses and explanations remained outstanding to 30 exceptions (informal queries) issued during the course of the audit.
- (c) Council approval of the 2004/2005 financial statements as submitted for audit purposes on 31 August 2005\*

(d) Council approval of appropriations amounting to R145,6 million\*.

(\* These matters were considered at the Council meeting of 1 December 2005. The minutes and Council decisions related to these issues will only be ratified at the next council meeting, scheduled for January 2006.)

Arrangements to address the staffing and late provision of information will be made to prevent recurrence.

## 5.15 POST BALANCE SHEET MATTERS

Apart from those already mentioned in prior paragraphs, the following matters took place after year end and are considered significant to the affairs of the Metro:

- (a) No audit committee had been in place and as a result no meetings had taken place for approximately the first six months of the 2005/2006 financial year as only one member remained. Positions for committee members had still not been filled.
- (b) The High Court judgement handed down to set aside a three-year contract worth at least R500 000 to a supplier of bond paper. In addition, the judgement ruled that the Metro should reconsider all the bids.

## 6. APPRECIATION

**T**he assistance rendered by the staff of the Nelson Mandela Bay Municipality during the audit is sincerely appreciated.

S.M. Ngqwala  
for AUDITOR-GENERAL

East London  
20 December 2005



AUDITOR - GENERAL