APPENDIX I:

REPORT OF THE AUDITOR-GENERAL TO THE COUNCIL ON THE FINANCIAL STATEMENTS OF ETHEKWINI MUNICIPALITY FOR THE YEAR ENDED 30 JUNE 2005

1. AUDIT ASSIGNMENT

The financial statements as set out on pages 54 to 118, for the year ended 30 June 2005, have been audited in terms of section 188 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 Local Government: Municipal Finance Management Act, 2003 (Act No. 56 of 2003) (MFMA). These financial statements, the maintenance of effective control measures and compliance with relevant laws and regulations are the responsibility of the accounting officer. My responsibility is to express an opinion on these financial statements, based on the audit.

2. NATURE AND SCOPE

The audit was conducted in accordance with 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.

3. AUDIT OPINION

In my opinion, the financial statements fairly present, in all material respects, the financial position of eThekwini Municipality at 30 June 2005 and the results of its operations and cash flows for the year then ended, in accordance with the accounting practices prescribed by the Institute of Municipal Finance Officers and in the manner required by the MFMA.

4. EMPHASIS OF MATTER

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

4.1 Outstanding service debtors

The provision for doubtful debt represented 47% (2004: 40%) of gross debtors as at 30 June 2005. Outstanding service debtors as disclosed in note 10 to the financial statements increased by R200 million to R2,53 billion at 30 June 2005. The provision for doubtful debts amounted to R1,19 billion (2004: R0,94 billion).

The inability of certain debtors to pay for services rendered; the non-enforcement of the credit control policy; and the fact that debt was not regularly followed up, assessed and written off, contributed to the increase in the outstanding service debtors as well as the increase in the provision for doubtful debt. For example, the level of uncollected water debts of 120 days and more had escalated by R79 million to R415 million for the year under review. The provision for doubtful debt as increased by R76,6 million in order to provide for the uncertainty of collecting the long outstanding debts.

4.2 Water losses

Owing mainly to illegal connections, reticulation leaks, meter inaccuracies, reservoir overflows and burst water mains, the water wastage factor was calculated at 29% (2004: 31%). This water wastage was approximately 4% higher than the estimates used for the budget process and above the acceptable norm.

4.3 Financial management

Although financial and internal control systems were developed and documented, they were not consistently implemented and maintained throughout the year. Reconciliations and independent reviews were not always performed to enforce compliance with policies and procedures, while certain internal control measures did not function as intended.

The following serve as examples:

- The method used to value Investments was not always strictly applied in terms of the relevant accounting policy.

- In certain cases it was found that the accounting records were not reconciled with the Value-Added Tax (VAT) returns submitted to the South African Revenue Service (SARS).

- The year-end bank reconciliations were not always performed. Consequently, an unreconciled difference of R6,7 million existed for the Sinking Fund Investment balances.

- Regular independent reviews were not always performed to ensure compliance with procurement regulations. As a result the audit revealed four contracts with a total value of R26,4 million that were awarded without the original tax clearance certificates being submitted. The audit also revealed other contracts to the value of R4,5 million that were awarded without the point awarding adjudication forms being authorised.

- The year-end reconciliations of the ledger balances against the external loan confirmations were not always performed causing the disclosed balance of the external loans account to be understated by R11,7 million as a result of undetected errors such as interest due but not accrued (understatement of interest) of R5,2 million and a loan repayment R6,5 million (understatement of the bank account and liabilities) made on 4 July 2005 being pre-maturely accounted for at year-end.

- The cheque requisition signatory book was not signed-off by an authorised official for a cheque being used in a R300 million investment.

- Control measures to ensure accurate and complete take-on balances were found to be inadequate. As a result the former South Local Council's Sinking Fund Investment amounting to R8,5 million was incorrectly included in the Consolidated Investment Fund debtors.

- Proceeds from land sales amounting to R2,1 million were regarded as irrecoverable, as no payments were received during the year. However, no action had been taken against the defaulting debtors in terms of the approved policy and procedures.

- Four loans totalling R32,2 million were not recovered in terms of the loan agreements.

- Vehicles with a total value of R8,5 million were incorrectly capitalised before year-end while delivery took place after year-end.

4.4 Housing revenue

Supporting documentation for hostel rental received from a collecting agent, amounting to R1,5 million for the year, could not be produced for audit purposes. Consequently, the completeness of revenue collected from hostels could not be ascertained.

4.5 Consolidated annual financial statements

eThekwini Municipality did not submit consolidated annual financial statements, in terms of sections 122(2) and 126(1)(b) of the MFMA, to the Auditor-General for auditing.

Attention is drawn to paragraph 18 of the chief financial officer's report, which discloses that no consolidation had been prepared owing mainly to the differences in the accounting frameworks used by the entities during the year under review.

4.6 Possible impairment loss

The following two municipal entities that are operating under the ownership and control of eThekwini Municipality are technically insolvent:

- International Conference Centre Durban (Proprietary) Limited.
- Durban Marine Theme Park (Proprietary) Limited trading as Ushaka Marine World Property Limited.

Attention is drawn to note 37 to the annual financial statements and paragraph 16 of the chief financial officer's report, which disclose a possible need for the recognition of an impairment loss against these investments and the exercise that will be conducted to determine the extent of the impairment to the value of these investments.

4.7 Late submission of audit report

The finalisation of the audit report was delayed due to the follow up audit work required on the final management comments and the compulsory quality review processes of the Auditor-General that had to be completed.

5. OTHER AUDITS

5.1 Performance measurement audit

An evaluation has been performed on the controls implemented by the municipal manager during the financial year to develop and manage eThekwini Municipality's performance management system, as required by section 45(b) of the Local Government: Municipal Systems Act, 2000 (Act No. 32 of 2000). A separate report was issued in this regard.

6. APPRECIATION

The assistance rendered by the staff of eThekwini Municipality during the audit is sincerely appreciated.

Auditor-General

Pretoria

14 December 2005

AUDITOR-GENERAL

APPENDIX J:

RESPONSES TO THE AUDIT REPORT: YEAR ENDED 2005-06-30

Notwithstanding the fact that the Auditor General once again expressed an **unqualified** opinion, the following comments and recommendations are made in connection with his Report.

Paragraph references coincide with those in the report.

4.1. Outstanding service debtors

Whilst the municipality tries to adhere strictly to enforce its credit control policies, this is not always possible due to constitutional imperatives. Accordingly, the provision for bad debts has been increased to cater for possible debt write off, if deemed necessary. The credit control policy is reviewed at least once a year, with a view to improve collections. This can be evidenced by the adopting of a new policy with regard to arrear water debt, which became effective as from 1 September 2005. In effect, long-term water debtors are required, in terms of an agreement that has to be signed, to pay their current water bill in full. For each full monthly payment, 1/50 of the outstanding debt will be written off. This means that the full outstanding debt will be fully extinguished over a 50-month period by establishing a culture of regular payment of current accounts. Every effort would be made to improve collection of outstanding service debt.

4.2. Water losses

The water loss investigation was started in earnest in the 2002/2003 year and is continuing. The status of the water investigation and the various intervention implementations were summarised in a report to the Executive Committee, dated 7 July 2004, the target is to reduce the water loss to 25% in the medium term and 20% in the long term (5years).

1In addition to the above, a dedicated project team has been set up in the Water Unit with the sole purpose of addressing this particular problem. The team reports on a monthly basis to a meeting chaired by the Head: Water and it is heartening to note that some very real progress is being made, mainly as a result of the implementation of zonal meters. Notwithstanding this progress there is still on going illegal connections being made on a daily basis and consumers are becoming more and more inventive in finding means of bypassing the metering system, which adds to the challenge of the project team. In so far as the Water loss percentage is concerned the Auditor-General has been cautioned when comparing eThekwini's loss figures in any benchmarking exercise as the provision of this service in the eThekwini area faces many challenges that generally don't exist elsewhere.

4.3. Financial management

- **Valuation of Investments**

  The auditor's contention that the investments should be reflected at cost in terms of the accounting policy is correct. However, with the take on of the former Operating Entities, certain investments were reflected at valuation. Entries to reflect these investments at cost are being processed in the 2005/06 financial year.

- **Vat Reconciliation**

  A review of the entire vat system is currently being performed by Pricewaterhouse Coopers (PWC) and this would cover the vat reconciliation for the period ending to 30 June 2006.1

  This exercise will be completed by 30 June 2006. In addition, Council has also embarked on appointing its own in house Vat/Tax Specialist who will be able to take over from PWC. It is envisaged that the incumbent will be appointed in the current year.

- **Reconciliation of Sinking Fund Investment Balances with Bank confirmations**

  Bank statements/confirmations of fund balances are not issued by the respective institutions on a regular basis. However bank statements/confirmations will be requested at year end to ensure reconciliation between the council and the institutions records.

- **Procurement Regulations**

  C1opies of the reports considered by the Bid Adjudication Committee giving rise to the awarding of contracts to the value of R4, 5 million were subsequently made available to the Auditor-General.

  Every effort would be made to ensure strict compliance with the procurement policies, including the obtaining of original tax clearance certificates prior to the awarding of tender contracts, as required by Section 16 of the Preferential Procurement Regulations,2001.

- **Reconciliation of Ledger balances and External loan confirmations**

  The accrual basis of accounting for expenditure will be applied in respect of loan interest. As indicated in 4.3.3 above, confirmation of balances will be obtained from the respective institutions at year end and these will agreed to the ledger account balances. The adjusting entries will be processed in the 2005/06 financial year.

- **Cheque requisition signatory register**

This was a once off omission to record the transaction in the cheque signatory register. The entry was recorded subsequently in the register. However all other formalities and controls were adhered to when the investment was made and accordingly there would be no loss to council.

- **Take on balances**

The correct disclosure of the former South Local Council's Sinking Fund will be made in the 2005/06 financial year, as agreed with the auditor.

- **Irrecoverable Debtors-Land sales**

All loans will be monitored on a regular basis to ensure compliance with the relevant terms and conditions. Appropriate actions in terms of the debt collection policy will be taken timely to ensure recovery of loans.However, potential loss to the Council is minimal where land sales are cancelled. The property is retained and sold to an alternate buyer. Rates owing by the initial buyer may not be recoverable. There is currently a sufficient provision for doubtful debts write off.

- **Irrecoverable Loans- R 32,2 million**

These loans were granted to First Metro Company relating to four projects.

The repayment periods have been extended due to First Metro having not received their NHFC loans and institutional subsidies.The net asset value of First Metro is more than sufficient to cover the loan debts.

In addition to the above it is recorded that First Metro Housing has approached the Council with a view to being considered as a Council Entity, a request that is not supported and which has given rise to discussions which are ongoing at present and as a result of which the recovery of the loans in question have been put on hold for the time being.

- **Capitalisation of new vehicles- prior to delivery**

The order to acquire these vehicles for Water Services was confirmed on 29 April 2005.These vehicles required a large amount of accessories to be fitted, ranging from painting of special colours to the fitment of canopies, additional seats, tow bars, roof racks etc. and clearly, given the exceptional busy state of the motor industry in South Africa, it was not possible for the work to be completed by 30 June 2005.Although provision for payment of these vehicles had been done on an accrual basis, no physical payment was made prior to 30 June 2005.However, in future the appropriate accounting treatment as recommended by the auditor would be made.

4.4 <u>Housing Revenue</u>

The revenue collection for Hostels was outsourced to an external organization namely, SETA, appointed by the Provincial Dept of Housing.SETA'S contract has been terminated with effect from 30 June 2005.

Council is currently in the process of implementing an in-house billing system for all hostels.The new billing system will capture details in respect of each resident in the hostel whereby monthly bills will be rendered thus ensuring that the necessary controls can be put in place.Arrears relative to the old billing system administered by SETA cannot be identified and will not form part of the new billing system. It must be noted that due to the inaccurate records of tenants that were maintained by SETA, a fresh survey was undertaken by Council, which will be used to compile records for the new billing system.

4.5 Consolidated annual financial statements

It was not feasible to do a consolidation in the true sense of the word as the financial statements of eThekwini and its entities are prepared on different basis namely IMFO (fund accounting) and GAAP. With the implementation of GAMAP it would be more feasible to do a consolidation as from the 2005/06 financial year.

It must be noted, however, that various uncertainties and related communication between eThekwini and the Auditor-General as well as National Treasury took place to clarify the requirement to prepare consolidated financial statements. It was only on 10 November 2005, way after the deadline, that we received confirmation that National Treasury requires consolidation in terms of the Municipal Finance Management Act No.56 of 2003.

4.6 Possible impairment loss-Municipal Entities

A possible need for the recognition of an impairment loss relating to these entities was identified during the 2004/05 financial year. Furthermore, losses incurred by these entities would continue in the future. It is realized that the full value of investments/loan to these entities may not be recoverable in an arms length transaction. In this regard management will conduct an exercise to assess fair value that could be realised during a sale transaction. Since this exercise is yet to be performed it has been decided to delay the recognition of a possible impairment loss until this fairvalue appraisal process has been conducted.

5.1 Performance Management Audit

The auditor’s comment that a separate report on the performance management audit, is yet to be issued, is noted.