

ANNEXURE “A”

REPORT OF THE AUDITOR-GENERAL

**REPORT OF THE AUDITOR-GENERAL TO THE COUNCIL ON THE
CONSOLIDATED FINANCIAL STATEMENTS OF THE NELSON MANDELA BAY
METROPOLITAN MUNICIPALITY FOR THE YEAR ENDED 30 JUNE 2006**

1. AUDIT ASSIGNMENT

The Nelson Mandela Bay Metropolitan Municipality and group financial statements, as set out in pages 120 to 161, for the year ended 30 June 2006 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 are the responsibility of the accounting officer. My responsibility is to express an opinion on these financial statements, based on the audit.

2. SCOPE

The audit was conducted in accordance with the International Standards on Auditing read with *General Notice 1512 of 2006*, issued in *Government Gazette* no. 29326 of 27 October 2006. 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
- evaluating the overall financial statement presentation.

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

3. BASIS OF ACCOUNTING

The Municipality is required to prepare consolidated financial statements on the basis of accounting determined by the National Treasury, as described in the addendum to this report. However, the Municipality has deviated from this basis of accounting in certain instances as described in paragraph 4.1.1 below.

4. QUALIFICATION

4.1 PRESENTATION OF FINANCIAL STATEMENTS

4.1.1 BASIS OF PRESENTATION

The financial statements of the Nelson Mandela Bay Metropolitan Municipality (NMBMM) confirm that GAAP has been excluded from the basis of preparation. This is not in line with GRAP 3.12: *Presentation of financial statements*. In addition, other deviations from the applicable basis of accounting were also noted and communicated to the Municipal Manager during the course of the audit.

The NMBMM revised its accounting policies (paragraphs 7, 11, 12, 13 and 15) and notes (notes 2, 6, 20, 39(f) and 40) to reflect its viewpoints related to the areas where the prescribed standards were regarded as being impractical and not suitable for local government. In a number of instances, the revised accounting policies contained in the financial statements remain in non-compliance with the prescribed accounting standards. The table below summarises any impact of these deviations on the financial statements.

Accounting Policy reference	Impact on Annual Financial Statements	Audit Report paragraph
Paragraph 7 – Property, Plant and Equipment	GAMAP 17 requires impairment and useful lives of assets to be assessed periodically. Management has not done this and the matter is considered to have a material effect on the financial statements	4.4.1
Paragraph 11 – Accounts Receivable	IAS 39 requires an entity to subsequently measure its financial assets at fair value. Management does not consider it appropriate to disclose accounts receivable at fair value. This matter is not considered to have a material effect on the financial statements.	None
Paragraph 12 – Trade Creditors	IAS 39 requires an entity to subsequently measure its financial liabilities at amortised cost. Management does not consider it appropriate to carry trade creditors at fair value. This matter is considered to have a material effect on the financial statements.	4.3.1.2

Paragraph 13 – Revenue Recognition	GAMAP 9 prescribes that an estimate should also be made for RSC levy payers who did not submit a declaration. Management considered it prudent not to account for estimated levies where no declarations had been received. This matter is considered to have a material effect on the financial statements.	4.5.2.1
Paragraph 15.2 – Provision for Rehabilitation of Refuse Landfill Sites	GAMAP 19 requires that restoration/rehabilitation costs need to be provided for where an entity has a present obligation (legal or constructive) as a result of a past event. Management considers an obligation to only exist in respect of refuse landfill sites no longer in use. This matter is considered to have a material effect on the financial statements	4.3.2
Notes to the Financial Statements reference		
Note 2 – Long-term liabilities	Management amended the note to reflect the liability resulting from past and current service in terms of a dated actuarial valuation performed. The liability is materially understated and has a material effect on the financial statements.	4.2.1
Note 6 - Creditors	Management did not consider it necessary to discount the leave pay accrual to its present value as the obligation is short term of nature. This matter is not considered to have a material effect on the financial statements.	6.2.3.2
Note 20 – Service Charges	GAMAP 9 requires that all service charges be accounted for in the correct period. Management has not accounted for all revenue (service charges) for June 2006 and this matter has a material effect on the financial statements.	4.5.1
Note 39(f) – Contingent Liabilities: Post Retirement Benefits	Disclosure on the post-retirement liability is not in line with IAS 19. This is considered to have a material effect on the financial statements.	4.2.1
Note 40 – Operating leases	Additional disclosure was made with regards to operating leases, which is not in line with IAS 17. This matter, in addition to the limitation of scope noted within this report, is considered to have a material effect on the financial statements.	4.6.1

Furthermore, management is required to properly analyse financial risk at an account balance level and implement appropriate controls to minimise such risk. During my audit, I noted instances where management was not able to effectively do this.

In my view, it is this combination of non-compliance with the prescribed accounting standards and ineffective controls and processes that has resulted in significant misstatement of the financial position of the NMBMM as detailed in paragraphs 4 and 6 of this report.

4.1.2 STATEMENT OF CHANGES IN NET ASSETS

The Accumulated Surplus at the end of the year as per the consolidated financial statements amounts to R64.7 million (2004/05: R83.1 million). A review of the Statement of Changes in Net Assets (SCNA) revealed that various expenses and adjustments have been recognised directly as changes in net assets instead of being recognised in the statement of financial performance, leading to the surplus/deficit for the period. This is in contradiction to Generally Recognised Accounting Practice (GRAP) 1: *Presentation of Financial Statements* paragraph 115 which requires all items of revenue and expenditure in a period to be included in the surplus or deficit for the period.

As a result of the above, the Accumulated Surplus/Deficit is misstated by R393,3 million.

4.1.3 PRIOR PERIOD ERROR NOT CORRECTED/APPLIED RETROSPECTIVELY

As part of the it's Changes in Accounting Policy: Implementation of GRAP, the NMBMM accounted for the change to the recognising water inventory as a separately disclosable item in Note 18 to the financial statements, against its opening accumulated surplus to the value of R16.7 million. This change, however, was not applied retrospectively due to reasons of impracticability provided by management.

Generally Recognised Accounting Practice (GRAP) 3: *Accounting Policies, Changes in Accounting Estimates and Errors* paragraph 43 states that a prior period error shall be corrected by retrospective restatement, except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the error. GRAP 3 further requires that where retrospective restatement is impracticable for a particular period, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected be disclosed in the financial statements.

Although the NMBMM considers it impractical to retrospectively restate balances in this regard, it has not disclosed the reasons for impracticability in its financial statements.

4.2 NON-CURRENT LIABILITIES

4.2.1 LONG-TERM LIABILITIES: POST-RETIREMENT LIABILITIES

The total liability in respect of post-retirement benefits relates to ill-health retirements and medical-aid contributions, and was actuarially assessed in 2002 at R878,7 million (R625.7 million for past and current service and R253 million for future services).

A full liability of the NMBMM's defined benefit plans for post-employment benefits has not been recognised, as required by International Accounting Standard (IAS) 19/GAAP 116: *Employee benefits*. The last actuarial valuation was performed in July 2002 and applied the principles of a zero rate in determining the calculation as disclosed in Note 39(f) to the financial statements. In addition, IAS 19, paragraph 57 requires that the results of the valuation be updated with any material transactions and other material changes in circumstances (including changes in market prices and interest rates) up to the balance sheet date.

In terms of IAS 19, paragraph 50, the full liability in respect of the benefits earned by employees in return for their service in the current and prior periods should be raised in the books and records of the NMBMM. Notwithstanding the fact that the prior actuarial valuation is dated, the NMBMM estimated its liability for current and past services as R625,7 million. However, included in long-term liabilities is a provision for post-retirement liabilities only to the value of R298,9 million.

As a result, long-term liabilities are estimated to be understated and operating results overstated by an amount of R326,8 million.

4.3 CURRENT LIABILITIES

4.3.1 CREDITORS

Creditors as per the consolidated financial statements amounts to R544,8 million (2004-05: R501,7 million). As a result of the material matters detailed in the subsections below, I could not satisfy myself as to the validity, accuracy and completeness of the creditors balance.

4.3.1.1 Limitation of scope: supporting documentation not submitted

Section 62(1)(b) of the MFMA states that the accounting officer of a municipality is responsible for managing the financial administration of the municipality and must for this purpose take all reasonable steps to ensure that full and proper records of the financial affairs of the municipality are kept in accordance with any prescribed norms and standards. Various attempts were made to obtain information and supporting documentation. Although the NMBMM was allowed sufficient time to provide the information, not all information requested for audit was forthcoming.

As a result of inadequate controls, including insufficient physical control over the movement of files and source documents during the relocation of the Creditors Section in September 2006, a number of expenditure files requested for audit purposes could not be located. Consequently, the following could not be verified in all instances:

- The validity, accuracy and completeness of creditor invoices (R281,2 million).
- The validity of capital expenditure incurred (R2,2 million).
- The validity of expenditure related to operating expenses and inventory incurred (R3,1 million).

The total value of supporting documentation not submitted before the cut-off date for audit testing therefore amounted to R286,5 million.

4.3.1.2 Creditors reconciliations not performed

Section 65(2)(j) of the MFMA requires the accounting officer of the municipality to take "all reasonable steps to ensure that all financial accounts of the municipality are closed at the end of each month and reconciled with its records". Good financial management discipline requires of management to prepare reconciliations on key accounts and follow up and clear reconciling items on a monthly basis.

However, I found the controls and systems to be inadequate with regard to creditors reconciliations. Creditors reconciliations were not performed for the majority of the NMBMM's creditors. Reconciliations were only performed for 40 creditors (3, 2%) out of a total of 1 250. Where reconciliations were attempted, these were merely a listing of the unpaid invoices. No reference was made to the supplier's statement balance or other reconciling items.

Furthermore, contrary to IAS 39, the NMBMM did not consider it appropriate to carry trade creditors at fair value, as trade creditors are normally paid within 30 days from the date of receipt of the invoice. An analytical audit review of the total creditors days revealed that the average payment terms of the NMBMM were 57 days.

This misstatement of the above could not be quantified due to the absence of necessary information from the NMBMM's information and accounting system.

4.3.2 CURRENT LIABILITIES: PROVISION FOR RESTORING/REHABILITATING LANDFILL SITES

The NMBMM has not raised a liability in respect of the obligation for restoring/rehabilitating landfill sites, as it considers that an obligation only exists in respect of landfill sites no longer in use. In terms of GAMAP 19: *Provisions, contingent liabilities and contingent assets*, restoration/rehabilitation costs need to be provided for. The accounting policy to the financial statements (paragraph 15.2) indicates that apart from the rehabilitation costs already expensed, it is management's intention to raise a provision to meet the ongoing rehabilitation costs in future.

The NMBMM currently operates the Arlington and Koedoeskloof landfill sites, of which closure – although not current – is imminent. In addition, an operational permit for continuation with waste disposal operations was declined by the Department of Water Affairs and Forestry (DWAF). The DWAF also insisted on the closure of the Ibhayi landfill site with effect from 30 June 2006, with the necessary rehabilitation required in accordance with the Environmental Conservation Act, 1989 (Act No. 73 of 1989). During the audit visits, it was evident that the upper landfill area did not comply with all rehabilitation requirements, such as being investigated to determine closure requirements and the actual condition of the landfill site being compared to the required condition.

The above matters impose an obligation on the NMBMM to provide for amounts in relation to the rehabilitation for eventual closure as required by the DWAF. As management has not yet estimated the potential liabilities in respect of the closure, the extent to which the above is misstated could not be determined.

4.4 NON-CURRENT ASSETS

4.4.1 PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment amounted to R3,1 billion as disclosed in Note 8 to the consolidated annual financial statements. As a result of the uncertainties detailed in the subsections below, combined with inadequate controls and systems, the extent to which property, plant and equipment may be misstated could not be determined.

4.4.1.1 Physical verification, reconciliations and valuations not performed

The NMBMM embarked on an exercise to physically identify all items of property, plant and equipment during the 2005-06 financial year, including all infrastructural and movable assets. The asset management plan developed to comply fully with the MFMA section 63 requirements and related policies regarding internal control and the management of property, plant and equipment, had not been finalised and approved by 30 June 2006.

The following had not yet been undertaken or completed:

- A reconciliation of all physical verification projects against the existing fixed asset register to confirm that the asset register is accurate and complete.
- Not all land identified during an internal verification was included in the fixed asset register.
- The useful lives of the identified assets were not assessed for appropriateness and the accuracy of book values for property, plant and equipment was not determined.
- The NMBMM did not assess its assets for indications of impairment. As reported under paragraph 6.3.1 of the present report, material amounts of revenue were lost due to water losses not unaccounted for. The water reticulation systems serve as an example of where impairment should be considered, as the revenue generated does not match the expense of operating the asset.

4.4.2 LAND

Land identified during a previous internal land verification exercise, mainly consisting of municipal land inherited, was included in the fixed asset register at a nil value. *GAMAP 17: Property, plant and equipment* requires that assets acquired at no cost be initially recognised at fair value. Management has indicated in paragraph 8 of the accounting policy to the financial statements that the fair value of land will only be determined within the next two years, as part of the municipal property valuation to be conducted in terms of the Property Rates Act, 2004 (Act No. 6 of 2004).

Property held for resale has been disclosed as a post balance sheet event (refer to Note 38 to the financial statements). These assets relate to land pockets to be sold subsequent to financial year-end. Land held for re-sale and thus land pockets sold should have been reflected as inventory. This matter was reported on in the prior year's audit report as well.

In general, there is uncertainty regarding land that should be classified as property for re-sale (inventory), investment property and/or as part of property, plant and equipment, since management has not clearly made such a determination. The extent of this misstatement is therefore not known.

4.5 REVENUE

4.5.1 SERVICE CHARGES NOT ACCOUNTED FOR

Revenue from service charges should be recognised when it is probable that the economic benefits would flow to the entity and the revenue can be measured reliably in terms of paragraph 37 of GAMAP 9: *Revenue*. This was not complied with, as service charges for June 2006 should have been fully recognised, notwithstanding that such charges had not been invoiced at 30 June 2006. As a result, revenue and consumer debtors are understated by an amount of R7,8 million.

Furthermore, the required details of consumer debtors have not been fully disclosed in terms of IAS 32: *Financial instruments – disclosure and presentation*.

4.5.2 REVENUE FROM REGIONAL SERVICES COUNCIL (RSC) LEVIES

4.5.2.1 RSC levy debtors

Paragraph 52 of GAMAP 9: *Revenue* prescribes that an estimate should also be made for RSC levy payers who did not submit a declaration. It states, “The revenue will be determined from declarations actually received by due date of the payment, together with an estimate of levies due when a levy payer has not submitted a declaration in the reporting period where payment was due.”

Paragraph 13 (sub-paragraph 4) of the accounting policy to the financial statements states that the NMBMM did not recognise all RSC levy income on the accrual basis at year-end, because of prudence considerations in view of the small likelihood of recovery due to the abolishment of RSC levies as from 1 July 2006.

Consequently, as a result of inadequate monitoring, RSC levy revenue and debtors have been understated by an amount of R25,1 million.

4.5.2.2 Inherent uncertainty and completeness of RSC levy income

Levy income in the consolidated financial statements amounts to R268,7 million (2005: R229,2 million). Due to the inherent uncertainties relating to the system of collecting RSC levies, such as an incomplete register of levy payers and the integrity

of the financial information submitted by levy payers on a self-assessment basis, the completeness and accuracy of levy income could not be verified. Furthermore, in the NMBMM's efforts to identify non-registered levy payers, 25% of the businesses sampled during the audit were not registered.

4.6 EXPENDITURE

4.6.1 GENERAL EXPENSES: LEASES

The total value of operating leases disclosed in note 40 to the financial statements amounts to R1,14 million. However, according to the Council's accounts (summarised in the trial balance), lease expenditure amounted to R106 million. In addition, the disclosure requirements of IAS 17: *Leases* have not been fully met, as the only disclosure in terms of finance leases is made in note 38 relating to events after the reporting date. Apart from the above-mentioned difference and non-disclosure, not all lease information requested was provided for audit purposes. These deficiencies are a result of the NMBMM not having proper lease management processes.

As a result, the application of the NMBMM's accounting policy could not be verified. The extent to which finance leases may have been incorrectly classified and accounted for as operating leases could also not be determined. The extent of financial misstatement could not be determined as a result of the uncertainties as indicated above, but is expected to be material.

4.6.2 GENERAL EXPENSES: HOUSING CONTRACTS

4.6.2.1 Limitation of scope: housing agreements not submitted

Not all the housing agreements requested could be provided for audit purposes due to inadequate record keeping. As a result, it was not possible to obtain adequate assurance with regard to the validity of housing contract payments to contractors.

4.6.2.2 Excess payments for work in progress

Based on the information that was provided for audit purposes, contractors had been paid in excess of the allocated housing project budget. Instances were found where payments amounting to R5,3 million were in excess of the value of completed units. These excess payments are therefore considered to be possible irregular expenditure.

4.6.2.3 Contract, internal schedule and documentation discrepancies

- (a) Discrepancies were noted with regard to the amounts in the actual housing contracts entered into and the letters of award as per the tender process being either inclusive or exclusive of VAT.
- (b) Overall record keeping and project management schedules did not agree with information contained in the contracts.
- (c) The individual pages of the contracts had not been signed by the various parties that had entered into the agreement.
- (d) Some pages of the tenders had not been completed by the various parties.

The above are the result of inadequate record keeping and monitoring of controls in the Housing and Land Business Unit. The financial implications of the above could not be determined.

5. ADVERSE AUDIT OPINION

In my opinion, because of the effect on the financial statements of the matters referred to in section 4, the financial statements do not present fairly, in all material respects, the financial position of the Nelson Mandela Bay Metropolitan Municipality and group at 30 June 2006 and the results of their operations and cash flows for the year then ended, in accordance with the basis of accounting determined by the National Treasury of South Africa, as described in the addendum to this report, and in the manner required by the Local Government: Municipal Finance Management Act, 2003 (Act No. 56 of 2003) and the Companies Act, 1973 (Act No. 61 of 1973), where applicable.

6. EMPHASIS OF MATTER

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

6.1 INTERNAL CONTROL AND CONTROL ENVIRONMENT

The control environment includes the actions of management and those charged with governance concerning the entity's internal control and its importance in the entity. The environment at the NMBMM was not conducive to promoting and sustaining good financial management. Issues reported on in the following paragraphs are attributed to:

- capacity issues (vacancies in various business units)
- competency and skill issues (lack of structured training programmes to address skills gaps)
- participation by those charged with governance (internal audit, audit committees, etc.)
- system issues.

6.1.1 CONTROL WEAKNESSES NOTED

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 years' audits were brought to the attention of management by means of various management letters and dialogue through the Audit Steering Committee. As these matters remain reported, it is evident that the controls are not functioning effectively.

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

- (a) Management did not always timeously address risks identified in the overall risk assessment. The risk assessment of one business unit had also not been finalised. Furthermore, only three business units out of a total of eleven submitted regular progress reports on their risk assessments performed.
- (b) No reconciliation was performed between the physical and theoretical stock held at the various stores of the NMBMM on a monthly basis and at year-end.
- (c) Performance contracts were only in place down to office manager level.
- (d) Roles and responsibilities had been defined in terms of delegations of authority and were in place up to office manager level, but not for other levels of employees who also performed authorising functions.

6.1.1.2 Implemented controls that had not functioned properly or were not adhered to at all times are listed below:

- (a) Segregation of duties was not always effective, most notably for the journal management system and the fuel stock system.
- (b) Independent checks were not always performed with regard to various accounting and control functions.

- (c) Recommendations from the Internal Audit Division to improve and modify internal controls were not implemented by management in all instances.
- (d) External audit recommendations in respect of controls were not implemented in all instances.

6.1.2 INTERNAL AUDIT

As previously reported, the Internal Audit Division did not attend to all the matters contained in the internal audit plan, with minimal work being performed on the full internal control and accounting systems of the NMBMM. Deviations from the audit plan resulted in all planned audits not being conducted. This is also due to the large number of forensic assignments the Internal Audit Division is required to perform.

6.1.3 AUDIT COMMITTEE

The current Audit Committee was only established during March 2006, which was eight months into the 2005-06 financial year. Various duties and functions of the Audit Committee were therefore not undertaken.

6.2 EXPENDITURE

6.2.1 TENDERS: SUPPLY CHAIN MANAGEMENT

Despite the adoption of the new Supply Chain Management Policy in October 2005 and the additional control measures instituted by the Council, the following unsatisfactory matters reported in the previous year were still evident during the review of tenders. This is primarily due to inadequate monitoring, controls and processes.

6.2.1.1 Limitation of scope: access to database not provided

The NMBMM engaged the services of an external service provider to verify the validity of the companies tendering and to maintain a database of approved suppliers. Tests on selected quotations provided by the suppliers were limited to the schedules already prepared by the external service provider and could not be corroborated by inspecting the original data. Requests were made to the external service provider to provide all supporting documentation submitted by the suppliers in

terms of the tender requirements, but only quotations and the schedule of preferential points calculated were provided.

This information provided was therefore insufficient to verify, amongst other things, the existence of the companies, their black economic empowerment (BEE) status and the clearance of municipal accounts (rates and services owing), as required by the NMBMM's Supply Chain Management Policy. As an alternative approach, the auditors sought access to the database to inspect the scanned documents, but even after several follow-ups, access could not be provided until after the cut-off date for submission of information due to delays caused by the service provider.

As a result, compliance with the Supply Chain Management Policy in this regard could not be adequately confirmed on a sample of quotations totalling R21 million, ranging from R10 000 to R200 000.

6.2.1.2 Non-adherence to the Supply Chain Management Policy

- (a) Tenders were awarded to contractors who did not score the highest points. The reasons presented for these deviations from the Supply Chain Management Policy were not considered to be reasonable and justifiable.
- (b) Clearance certificates required prior to the awarding of contracts were not always evident on contract files.
- (c) Tender documents were not always signed by the supplier who was awarded the contract.
- (d) Points awarded to suppliers were incorrectly calculated, as the percentage split between price and equity was not correct.
- (e) Suppliers contracted were not those suppliers recommended at evaluation.
- (f) Tenders were awarded to suppliers who did not submit all tender documentation.

Not awarding a tender to the supplier who obtained the highest procurement points does not in itself result in non-compliance with the NMBMM's Supply Chain Management Policy. It is, however, a requirement of the policy to document the reason why the supplier with the highest points was not awarded the tender. These reasons were not documented.

6.2.1.3 Formal tender scoring system

The following weaknesses were identified when assessing the implementation of the formal tender support system (FTSS):

- (a) Requisition numbers were not always loaded on the FTSS and as a result, it was not possible to link the contracts with the actual orders on the stores and creditors system.
- (b) A reconciliation was not done between the FTSS and the accounting system to ensure that orders were valid, accurate and approved at adjudication level. Neither were any deviations investigated.
- (c) The specifications (including the funds available on the budget) and recommendation to the adjudication committee were not loaded on the system.
- (d) The business unit responsible for the contract was not always loaded on the system.
- (e) Contract numbers were not always loaded on the system, making it difficult to follow up on queries.
- (f) The system did not autogenerate sequenced numbers when contracts were captured, to enhance control over the completeness of all contracts awarded as captured on the system.

6.2.2 EMPLOYEE-RELATED COSTS

Due to a lack of proper internal controls and monitoring, as well as poor record keeping, the following significant issues were noted:

6.2.2.1 Poor administration and record keeping within the Human Resources Business Unit

- (a) Certain files and documentation relating to new appointments could not be submitted for audit purposes.
- (b) Personnel were appointed who did not meet the requirements for the post.
- (c) In some instances, evidence of the required qualifications was not placed on file.

- (d) Due to poor record keeping, documentation supporting the validity and accuracy of certain allowances and bonus payments to employees could not be found on the personnel files.
- (e) Leave records were found to be incomplete, not filed timeously and inaccurate in some instances. A number of leave records could also not be presented for inspection.

6.2.2.2 Leave pay accrual

The leave records on the personnel system were used as the basis for calculating the R70 million leave pay accrual disclosed in note 6 to the annual financial statements. Leave records were found to be unreliable due to inadequate controls, since they were not regularly updated or did not exist. It was therefore not possible to verify the accuracy, validity and completeness of the leave pay accrual.

6.3 WATER UNACCOUNTED FOR

Water not accounted for as a percentage of water available for distribution increased from the prior year, despite management's strategies to reduce the amount of water losses. The following table is a summary of estimated losses (percentage and rand value) incurred over the past three years, indicating a steady deterioration:

Financial year	2005-06	2004-05	2003-04
Percentage of water losses	28,5%	24,5%	21,3%
Rand value of water losses (excess over Council-considered norm)	R44,3 million	R28,9 million	R18,7 million

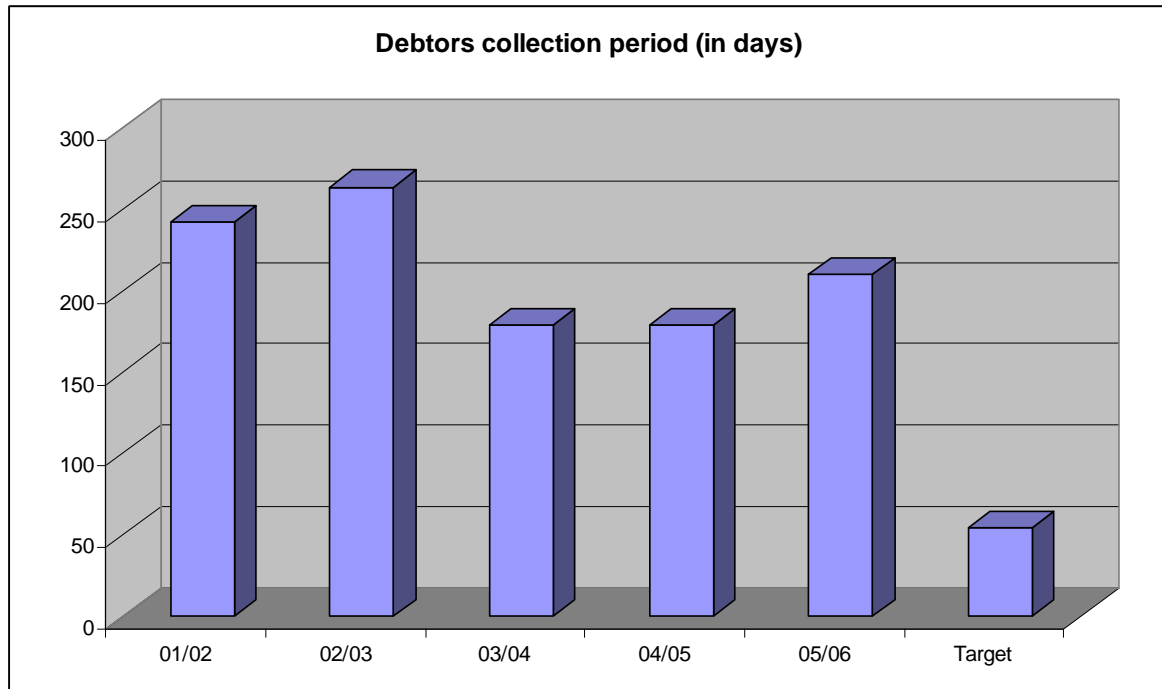
These figures indicate that 1 of out every 3,5 litres of water is unaccounted for (2005: 1 out of every 4 litres).

6.4 DEBTORS

6.4.1 COLLECTION OF OUTSTANDING DEBT

The total gross balances of outstanding consumer debtors amounted to R1,164 billion (2004-05: R963,5 million), as disclosed in note 13 to the consolidated financial statements.

The Council had initially set a target debtors collection period of 42 days, which was revised in May 2006 to 55 days. At 30 June 2006, the service debtors collection period amounted to 210 days. The debtors' collection periods for the past five years are noted in the following chart:



Section 96(b) of the Local Government: Municipal Systems Act, 2000 (Act No. 32 of 2000) (MSA) requires that a municipality adopt, maintain and implement a credit control and debt collection policy that 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 target set by the Council.

6.4.2 HOUSING PENALTIES NOT CHARGED IN TERMS OF CONTRACTS ENTERED INTO

Not all housing agreements requested for audit purposes were provided. However, based on the information received for audit purposes, housing penalties as stipulated in housing contracts were not charged to contractors for the late completion of housing units, due to inadequate financial management discipline. As a result, estimated revenue in the form of interest and penalties for 2005-06 is understated by an amount of R27,5 million.

As this matter was also reported on in prior years, the table below is an estimation of the penalties that were not previously charged:

Financial year	2003-04	2004-05
Amount: penalties not charged	R11,8 million	R40,8 million

The combined effect of the penalties not charged is that the accumulated surplus and other debtors balances are understated by an estimated amount of R80 million. On the other hand, the recoverability of the uncharged penalties and interest was also not assessed, which could reduce the amount of the understatement by an unknown amount.

6.4.3 ASSESSMENT OF DEBTORS

IAS 39: *Financial instruments: recognition and measurement*, paragraph AG 87 states that a credit rating system should be used when determining a provision for doubtful debts. The NMBMM provides for all debt over 90 days in accordance with its accounting policy. This provision amounted to R626 million at year-end.

Management has not performed a proper assessment of credit risks of customer profiles and payment patterns in determining this provision. As established through audit tests, the principles used as a basis for calculating the provision for doubtful debts were not reasonable.

6.5 ASSET MANAGEMENT

6.5.1 BANK BALANCES AND CASH

The balance disclosed as cash resources in the consolidated statement of the financial position at year-end amounted to R53 million (2004-05: R61 million).

As a result of bank reconciliations not being adequately followed up and cleared on a monthly basis, the following were noted:

- (a) Long-outstanding items older than six months to the net value of R5,4 million were noted for certain reconciliations.
- (b) The main account bank reconciliation contains reimbursement adjustments dating back to November 2005.
- (c) The presentation (format) of the main bank reconciliation is inappropriate. The reconciliation of the bank account used to pay creditors contains various “reconciling” items regarding over- and under-reimbursements to and from the main bank account. These reimbursements date back to January 2000. The reconciliation was also prepared using cumulative figures, for example, amounts reimbursed represent the total of all reimbursements processed since the introduction of the stores and creditors system.

Although, the financial statements are not materially misstated in this regard, the control deficiencies are a concern.

6.5.2 INVENTORY MOVEMENTS NOT RECORDED IN CORRECT PERIOD

The value of inventory in the consolidated financial statements amounts to R82,5 million (2004-05: R75 million).

The following were noted during the audit with regard to stock not recorded in the correct financial year, due to a lack of compensating controls to mitigate system limitations:

- (a) Vouchers for goods that were receipted or issued during the 2005-06 financial year were captured on the system in the 2006-07 financial year.
- (b) Fuel purchases before year-end were only recorded after year-end.
- (c) Goods received advices were recorded in the incorrect financial year.
- (d) Goods requisitions dated in the prior financial years were only recorded in the financial period ended 30 June 2006.

Although, the financial statements are not materially misstated in this regard, the control deficiencies are a concern.

6.5.3 VEHICLES

Due to inadequate internal controls and ineffective monitoring by management, the following significant control weaknesses relating to the management of Council vehicles were noted:

- (a) Accidents were not always reported, accident reports were not always completed and no action was taken against negligent drivers.
- (b) Trip authorisation forms were not used for all vehicles and it could not be confirmed that the use of the vehicles had been authorised in all instances.
- (c) Vehicle inspection forms were not always completed.
- (d) In certain instances, trip authorisation forms were not completed properly, while the completeness and reasonableness of kilometres travelled were not checked or verified by senior officials.
- (e) In certain instances trip authorities could not be submitted for audit purposes.

6.6 IRREGULAR AS WELL AS FRUITLESS AND WASTEFUL EXPENDITURE

In terms of section 32(4) of the MFMA, on discovery of any irregular expenditure or any fruitless and wasteful expenditure, the accounting officer of a municipality must promptly report, in writing, to the mayor, MEC for Local Government and the Auditor-General, (a) the particulars of the expenditure; and (b) any steps that have been taken to recover the expenditure and to prevent a recurrence of the expenditure.

No amounts have been disclosed as being irregular, unauthorised, or fruitless and wasteful expenditure. The accounting policies (19 to 21) indicate that these types of expenditure are accounted for as expenditure in the Statement of Financial Performance and where recovered, they are subsequently accounted for as revenue in the Statement of Financial Performance. However, no such expenditure has been separately disclosed. The Internal Audit Division has been tasked with compiling a list of these types of expenditure for further investigation and comment by the various business units.

Notwithstanding the above, it is clear that the NMBMM did not have adequate systems or procedures in place during the 2005-06 financial year to identify, segregate and appropriately address these types of expenditure. Currently, the process is fragmented with no central administrative function or unit to specifically deal with items of this nature.

This concern has to be considered in the context of all previous and current forensic and other audits performed by the Internal Audit Division and the results thereof as well as all Auditor-General queries in this regard that have already been communicated through this audit report and in management letters.

Furthermore, during the period under review, five key officials (including senior management members) were suspended. In general, the disciplinary process was not finalised in a timely manner and officials still received their salaries during this period. This constitutes potential fruitless expenditure of R1,9 million.

6.7 POTENTIAL FOR FRAUD

There are various conditions or events that increase the risk of fraud and error. These include:

- (a) The Anti-fraud and Corruption Policy had not been updated to be in line with the MFMA and was not being implemented as intended.
- (b) A persistent failure to correct major weaknesses in internal control (re-reported items).
- (c) Significant and prolonged understaffing of business units with the effect that competent, experienced and suitable staff was not always available.
- (d) A breakdown in control systems, especially those mentioned in this report.
- (e) Corporate governance structures, such as the Internal Audit Division and the Audit Committee, did not function throughout the year as required by the MFMA (refer to paragraphs 6.1.2 and 6.1.3).
- (f) The poor administration of housing contracts and inadequate control and monitoring of payments (refer to paragraph 4.6.2).
- (g) The non-recovery of penalties for housing projects not completed by due dates (refer to paragraph 6.4.2).
- (h) The non-compliance with the Supply Chain Management Policy in certain instances (refer to paragraph 6.2)

6.8 ENVIRONMENTAL, SUSTAINABLE DEVELOPMENT, AND OCCUPATIONAL HEALTH AND SAFETY ISSUES

The following is a summary of the key findings noted during the environmental review, the details of which were communicated to the NMBMM in a management letter:

Area	Matter
Motherwell Canal discharge point	Pollution from sewerage discharged and solid waste into the Swartkops River. An action plan was implemented, but no significant improvement noted since prior year's audit.
Walmer Township	Use of decommissioned landfill site. An action plan was implemented, but no actual improvements or developments materialised since prior year's audit.
Internal audit involvement	The current audit plan provides for environmental audits to be conducted, but the effective implementation of the plan is severely hampered by a lack of resources.
North End Lake pollution	Results of the bacteriological quality testing of water done between July 2005 and October 2006 revealed readings exceeding acceptable limits.
Swartkops River pollution	Water sampling obtained from Swartkops River (between January 2005 and October 2006) revealed readings exceeding acceptable limits in certain identified areas.
Sewage leaks into natural water systems	Overflowing of sewage effluent into natural water down-flow and onto sensitive vegetation in the Baakens River occurs regularly.
Hlalani Settlement (Soweto-on-Sea)	Health and safety concerns emanating from excessive littering and waste discharges into the Chatty River had not been addressed since the prior audit. The situation has deteriorated since the audit visit conducted on 13 October 2005.

6.9 MUNICIPAL ENTITIES

Details of the separate audits conducted at the following municipal entities related to the NMBMM are as follows:

Municipal entity	Result of 2005-06 audit	Key finding resulting in audit opinion	Grant received from the NMBMM in 2005-06 (refer to note 32.7 of the NMBMM's financial statements)
Mandela Bay Development Agency	Unqualified opinion	<ul style="list-style-type: none"> Irregular expenditure noted as a matter of emphasis. 	R10,9 million
Feathermarket Promotions	Qualified opinion	<ul style="list-style-type: none"> The entity did not determine residual values and useful lives for property, plant and equipment as required by GAMAP 17. Stock count not attended by auditors. 	R1 million

Municipal entity	Result of 2005-06 audit	Key finding resulting in audit opinion	Grant received from the NMBMM in 2005-06 (refer to note 32.7 of the NMBMM's financial statements)
Centenary Promotions	Disclaimer	<ul style="list-style-type: none"> • Opening balances of 2005-06 not verified. • Validity, accuracy and completeness of revenue transactions could not be verified. • Limitation of scope with regard to expenditure. • Incompleteness of debtors. • Provision for doubtful debts not reasonable. • Revenue incorrectly recorded with VAT in the general ledger. 	R0,05 million
Nelson Mandela Metropolitan Art Museum	Qualified opinion	<ul style="list-style-type: none"> • Limitation of scope on expenditure vouchers. • Expenditure amounts not recorded in the general ledger or recorded as incorrect amounts. • Expenditure amounts recorded in incorrect period. • Basis of presentation of annual financial statements. • Non-compliance with GAMAP 12: <i>Inventories</i>. • Non-compliance with GAMAP 19: <i>Provisions, contingent liabilities and events occurring after the balance sheet date</i>. 	R2,6 million

The impact of audit differences at the municipal entities on the results of the consolidated annual financial statements was not found to be significant.

However, the control environment, including the monitoring of controls, was inadequate at Centenary Hall Promotions and Nelson Mandela Metropolitan Art Museum, which has resulted in non-compliance with the MFMA and a modification of the relevant audit reports of those municipal entities. These matters have been reported separately within the relevant individual audit reports of the concerned entities.

7. LATE FINALISATION OF THE AUDIT REPORT

In terms of section 126(3)(b) of the MFMA, I am required to submit my report to the accounting officer within three months of the receipt of the financial statements. In the interest of improving accountability and due to the process implemented by me to

ensure consistency in the manner in which material audit findings are reported, I have delayed the finalisation of my report to the date reflected on this report.

8. APPRECIATION

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

Auditor-General

AUDITOR-GENERAL

Pretoria

30 March 2007



A U D I T O R - G E N E R A L

ADDENDUM TO THE REPORT OF THE AUDITOR-GENERAL ON THE CONSOLIDATED FINANCIAL STATEMENTS TO THE COUNCIL OF THE NELSON MANDELA BAY METROPOLITAN MUNICIPALITY FOR THE YEAR ENDED 30 JUNE 2006

Basis of preparation

The financial statements have been prepared in accordance with the Standards of Generally Recognised Accounting Practice (GRAP) and the Standards of Generally Accepted Municipal Accounting Practice (GAMAP), prescribed by the Minister of Finance in terms of:

- *General Notice 991 of 2005*, issued in *Government Gazette* no. 28095 of 7 December 2005
- *General Notice 992 of 2005*, issued in *Government Gazette* no. 28095 of 15 December 2005.

The standards comprise the following:

GRAP 1	Presentation of financial statements
GRAP 2	Cash flow statements
GRAP 3	Accounting policies, changes in accounting estimates and errors
GAMAP 4	The effects of changes in foreign exchange rates
GAMAP 6	Consolidated financial statements and accounting for controlled entities
GAMAP 7	Accounting for investments in associates
GAMAP 8	Financial reporting of interests in joint ventures
GAMAP 9	Revenue
GAMAP 12	Inventories
GAMAP 17	Property, plant and equipment
GAMAP 19	Provisions, contingent liabilities and contingent assets

Accounting policies for material transactions, events or conditions not covered by the above GRAP and GAMAP standards have been developed in accordance with paragraphs 7, 11 and 12 of GRAP 3. These accounting policies and the applicable disclosures have been based on the South African Statements of Generally Accepted Accounting Practice (GAAP), including any interpretations of such statements issued by the Accounting Standards Board.

ANNEXURE “B”

REPORT OF THE AUDIT COMMITTEE

**NELSON MANDELA BAY METROPOLITAN MUNICIPALITY - ANNUAL
REPORT OF THE AUDIT COMMITTEE FOR THE FINANCIAL YEAR
ENDED 30 JUNE 2006**

PURPOSE

In accordance with the *Municipal Finance Management Act* No. 56 of 2003, the Audit Committee must review the annual financial statements of the Council to provide an authoritative and credible view of the financial position of the Municipality, its efficiency, effectiveness and its overall compliance with the MFMA and other legislation.

In terms of its Charter, the Audit Committee must report annually to the Council and the Executive Mayor on its activities, performance management matters, as well as recommendations and decisions of the Audit Committee during the previous financial year. Below is the annual report of the Audit Committee for the 2005/2006 financial year.

CHAIRPERSON'S REPORT

Final Audit Committee Report

Nelson Mandela Bay Metropolitan Municipality: Financial Year ended 30 June 2006

The Audit Committee of the NMBM was appointed in March 2006 by the Council in terms of the MFMA No. 56 of 2003 (Section 166) and the Municipal Planning and Performance Management Regulations, No. 796 of 2001. It is important to note that this was eight months into the financial year under review (2005/2006), leaving little opportunity for it to have a significant influence on the financial statements for the year ended 30 June 2006.

During the year under review, the NMBM Audit Committee consisted of the following external members:

Sakhiwo Glen Zamisa (Chairman)

Professor David Rosenberg

Ms Ronel Shaw

Audit Committee meeting dates during the year under review:

1. 29 March 2006
2. 28 July 2006
3. 05 October 2006
4. 29 March 2007

Notwithstanding its relative short tenure, the Audit Committee presided over the consolidated Financial Statements of the Municipality in terms of the adopted Audit Committee Charter, Section 5 (Duties and Responsibilities of the Audit Committee). These responsibilities require the Audit Committee to review the annual financial statements prior to approval by the Council in order to provide the Council with an authoritative and credible view of the financial position of the Municipality. The Audit Committee also has responsibilities relating to the Internal Audit Division as well as relating to the external audit function performed by the Office of the Auditor-General.

The Audit Committee has viewed with concern the fact that the Auditor-General has passed an adverse opinion on the financial statements of the Municipality for the year ending 30 June 2006. This qualification is attributed to non-compliance with prescribed accounting standards and ineffective controls and processes, resulting in the significant misstatement of the financial position of the Municipality. Based on the commitment and professionalism shown by the staff at the Office of the AG, the Audit Committee has no wish to dispute the comprehensive findings that have led to this opinion by the Auditor-General. It is also the view of the Audit Committee, based on the AG's findings, that the Internal Audit Division was not able to fulfill its responsibilities effectively, due to capacity constraints.

The effect of the Qualification and Adverse opinion passed on the financial statements of the Nelson Mandela Bay Metropolitan Municipality is that stakeholders cannot place any assurance on the governance of the entity.

However, the Audit Committee is encouraged and convinced that, with the appointment of the current Municipal Manager, there is renewed commitment to address the challenges of effective internal controls and clean governance within the Municipality. This resolve will be successfully implemented if key vacancies, as identified in the audit report, are filled with adequately skilled and qualified personnel. The Audit Committee is also encouraged by management responses and plans to be instituted in resolving every finding on the qualification and emphasis of matters to individuals. In order to complement these plans and ensure accountability, an effective performance management system should be implemented and maintained at all times within the municipal entity.

The Internal Audit Division and other relevant structures should give proper guidance to all business units and ensure that they assist the municipal Council in instituting a culture of effective governance and achievement of unqualified financial reports in the future. It is also hoped that the working relationship between the Internal Audit Division, the Auditor-General's office and the Audit Committee will become closer and stronger in order to ensure an effective control environment within the Municipality.

In conclusion, the Audit Committee would like to acknowledge the co-operation and support it received from the Internal Audit staff and the Office of the Municipal Manager during the financial year under review.

ANNEXURE “C”

RESPONSES TO THE AUDIT REPORT

**NELSON MANDELA BAY METROPOLITAN MUNICIPALITY –
RESPONSES TO AUDIT REPORT ON CONSOLIDATED FINANCIAL
STATEMENTS FOR YEAR ENDED 30 JUNE 2006**

PURPOSE

In accordance with the *Public Audit Act No. 25 of 2004*, the Council has to consider the audit report within one month after its first sitting after the audit report has been submitted by the Auditor-General (Annexure “A”).

Detailed below are the comments, with reference being made to the paragraph numbering in the audit report:

4.1 PRESENTATION OF FINANCIAL STATEMENTS

4.1.1 BASIS OF PRESENTATION

The issues raised pertaining to the effect on the financial statements, will be responded to under the relevant paragraphs in the audit report, where considered necessary.

4.1.2 STATEMENT OF CHANGES IN NET ASSETS

This issue was not reported on by the Auditor-General’s Office as part of the initial informal audit query system and first surfaced in the Draft Auditor-General’s report of 23 March 2007, as a qualification item, several months after the completion of the Consolidated Financial Statements, on 30 September 2006. Management was therefore not in a position to respond to it previously.

The AG’s contention that the accumulated surplus is misstated, is not considered to be factually correct. The accumulated surplus for the financial year ended 30 June 2006 was indeed R64,7 million, after the relevant revenue and expenditure items were taken into account.

It is acknowledged that the presentation of the Statement of Changes in Net Assets (SCNA) requires refinement. The presentation of the SCNA will accordingly be addressed in the 2006/07 Financial Statements.

4.1.3 PRIOR PERIOD ERROR NOT CORRECTED/APPLIED RETROSPECTIVELY

Management is aware that the prior year's financial statements should have been restated. In order to perform the restatement, the value of the opening inventory for the 2004/05 financial year would have been required, which was unfortunately not available as the recording of the value of water inventory only commenced in the 2005/06 Financial year.

The necessary disclosures will therefore be made in the 2006/07 Financial Statements.

4.2 NON-CURRENT LIABILITIES

4.2.2 LONG-TERM LIABILITIES: POST-RETIREMENT LIABILITIES

As there was no applicable GAMAP standard in the 2004/05 financial year, the AG's local office assessed the reasonableness of the Municipality's approach in dealing with post-retirement benefits. As the Municipality had adopted a strategy to fund the liability in respect of post-retirement benefits over a fifteen-year period, taking into account financial affordability constraints, the AG concluded in that year's report that the Municipality's approach was appropriate, with the result that this matter was not qualified in the Municipality's audit report.

For the 2005/06 audit, however, the AG's office relied on GAAP, as it is deemed to be the applicable standard. As a consequence, this matter has now become a qualification, as GAAP requires the total liability to be accounted for in one financial year. It is noted that GAAP does not recognise

the financial position of local government in dealing with this liability and the consequential impact thereof on a municipality's Statement of Financial Position.

In order to comply with the relevant GAAP standard, management intends to record the entire liability in the 2006/7 Financial Statements, as required. This will result in a reduction in Council's net assets of at least R327 million, which will require strategies to eliminate it in future years.

Management is furthermore in the process of undertaking an updated actuarial valuation of its post-retirement benefit obligations, as it was last done in 2002, in order to accurately determine the amount of the liability – this updated valuation will be used to record the full liability as soon as it is completed.

4.3 CURRENT LIABILITIES

4.3.1 CREDITORS

4.3.1.1 Limitation of scope: supporting documentation not submitted

It is acknowledged that at the time of the audit, the required files and documents were difficult to locate, as the audit was conducted during a period when the Creditors Section was conducting major business process reviews and a relocation.

It is important to note that one of the main factors affecting proper access to documentation and loss of documentation was inadequate storage and office facilities for the Creditors Section. This problem had been ongoing for a number of years. An arrangement was entered into with Corporate Administration to obtain the required accommodation, and during September 2006, the Creditors Section undertook the relocation to accommodation that then became available. This relocation, however, coincided with the audit conducted by the auditors.

Efforts were made to locate and present the required documentation to the AG, but this was only achieved after the cut-of date for audit testing. The Auditors acknowledged receipt of the required source documents, but informed management that they could not be taken into consideration for audit purposes, as it was past the cut-off date.

This oversight in good planning and meeting timeframes set for audit purposes is noted. Management has put the following control measures in place in an effort to prevent a recurrence:

- An electronic Document Tracking System has been developed and is being implemented;
- A Papertrail Document Management System is being developed by IT and should be ready for implementation in the new financial year;
- Proper control over all source documents has been implemented and these are now filed in an appropriate sequence to facilitate easy access;
- Access to source documents is now controlled by a designated official.

4.3.1.2 Creditors reconciliations not performed

It is acknowledged that the reconciliation of creditors' accounts was not performed in full. This was due to a lack of skilled staff, aggravated by the fact that a number of staff members of the Creditors Section left Council's service in a short space of time, leaving a skills void that had to be filled by inexperienced temporary and junior staff.

The business process has been revised and a proposed organogram has been submitted for consideration. Temporary staff have in the interim been appointed to perform the required reconciliation of creditors' accounts.

It is the intention to review the Stores and Creditors system so as to ensure that the desired reports are produced to facilitate reconciliation.

4.3.2 CURRENT LIABILITIES: PROVISION FOR RESTORING/ REHABILITATING LANDFILL SITES

The Arlington and Koedoeskloof landfill sites will be operational for at least another 40 years, and their closure is therefore not imminent, as is suggested by the AG.

The following is the factual position relating to the sites in question:

Municipality's Operating Landfill Sites:

The Arlington Waste Site is operating under a legal permit, with the expected remaining lifespan being approximately 60 years. The permit conditions do not cite an expiry date for the permit. Only approximately 20% of the site has been filled with waste to date, with rehabilitation of the area anticipated to occur in approximately 20 years' time only.

Koedoeskloof is operating under a legal permit, with no time limit. Once fully developed, the expected remaining life span will be 50 years. Rehabilitation is taking place as each cell is completed. Discussions are well advanced, with a view of introducing a levy on the current disposal tariffs in order to build up a rehabilitation provision for both sites.

Municipality's Closed Landfill Site (Ibhayi)

The rehabilitation of the Ibhayi Landfill Site is a registered Municipal Infrastructure Grant project.

The project has been implemented in phases. As at May 2006, Phase 4 of the project was completed, resulting in rehabilitation of the lower portion of the site. Rehabilitation of the upper site is currently not possible, as the

approximately 3 000 households residing there have to be relocated by the Housing and Land Business Unit. (According the H&L, funding is currently being sourced externally for such relocation, Province being responsible for the allocation of housing budgets).

Once the final rehabilitation is completed, the site will be isolated from the immediate environment on account of landfill gas, leachate and stormwater and only then will a closure permit be issued.

In the meantime monitoring and auditing of the site is being conducted through a service provider contracted by the NMBMM.

Compliance with the accounting standard as set out in GAMAP 19 will be dealt with in preparation of the 2006/07 Financial Statements.

In order, however, to ensure compliance, the relevant rehabilitation costs will firstly have to be determined. Without the aforementioned determination, it is not possible to express a view on whether this matter will have a material effect on the financial statements

4.4 NON-CURRENT ASSETS

4.4.1 PROPERTY, PLANT AND EQUIPMENT

4.4.1.1 Physical verification, reconciliations and valuations not performed

All Business Units will be tasked to physically verify the assets under their control, including an assessment of the associated useful lives and a reconciliation of the assets with the fixed assets register. Once this exercise is completed, the necessary updating of the fixed assets register will be conducted.

The entire land assets base will only be fully included in the assets register once the municipal property valuation project, in conjunction with the land asset management project, is completed (estimated completion date : 30 June 2008).

The validity of associating water losses solely with asset impairment is disputed. Water losses are attributable to a myriad of reasons, including not billing all the water consumers in the city, i.e. not all water consumers are on the billing records and their consumption is accounted as water losses.

Furthermore, the Municipality is fully recovering the costs associated with the provision of the water service and does not anticipate any difficulty continuing to do so, which indicates no asset impairment in this case. A review of some other municipalities has revealed a water loss rate of 30%, which, whilst not desired, is considered to be within industry norms.

Asset impairment is usually applied to consumer or production related goods and services where impairment resulting from a change in technology or the loss of a dedicated consumer leads to some financial loss to an organisation. The organisation then suffers an impairment loss, as it may not be able to sell these products.

Management is also of the view that the results of any impairment assessment would most likely be immaterial, for the reasons stated above, whilst the cost to perform such a detailed study might be financially prohibitive. Management will accordingly explore this issue further with other similar municipalities, the Accountant-General and the Auditor-General in order to develop and implement the most appropriate actions to resolve the asset impairment issue.

4.4.2 LAND

The current municipal property valuation project will include the determination of the 'fair value' of land, which will be used to update the fixed assets register. Property records will also be analysed as part of the land asset management project to determine the classification of properties in relation to 'property held for resale', investment properties and property, plant and equipment and will be recorded under the appropriate categories in the Financial Statements.

4.5 REVENUE

4.5.1 SERVICE CHARGES NOT ACCOUNTED FOR

It is the intention to fully recognise service charges in the 2006/07 Financial Statements.

However, the amount of R7,8 million represents only 0,6% of the total electricity and water sales in the amount to R1,28 billion, and is not considered to have a material effect on the financial statements.

The AG's reference to IAS 32 pertaining to the Municipality's service charges income is considered inappropriate, as it refers to financial instruments such as equities and derivatives that are unrelated to the tariff income derived from consumer debtors. The disclosure requirements of IAS 32 are, however, not relevant to consumer debtors' income, as no financial instruments are recorded as income in the Municipality's books of account.

4.5.2 REVENUE FROM REGIONAL SERVICES COUNCIL (RSC) LEVIES

4.5.2.1 RSC levy debtors

An accrual in excess of R22 million was raised at year-end to account for RSC levy income received subsequent to 30 June 2006.

Due to the abolishment of RSC levies as from 1 July 2006, this matter will not impact on the 2006/07 Financial Statements.

4.5.2.2 Inherent uncertainty and incompleteness of RSC levy income

The incompleteness of RSC levy income has been mentioned in previous audit reports. This issue is not within the full control of the Municipality. The incompleteness of the income stems from shortcomings in the RSC levy legislation, as only the staff of SARS is permitted to audit the books of an enterprise to ascertain the correctness of the figures supplied.

Due to the abolishment of RSC levies as from 1 July 2006, this matter will not impact on the 2006/07 Financial Statements.

4.6 EXPENDITURE

4.6.1 GENERAL EXPENSES: LEASES

A major portion of the amount of R106 million quoted by the AG represents Council's internal lease and hire charges, such as automotive plant and vehicle lease charges amounting to R64.9 million; the occasional hire of vehicles, amounting to R28.2 million; and other internal hiring charges of R3.6 million, totalling R96.7 million.

The amount of R1.14 million, as disclosed in the notes to the financial statements, represents the external lease charges as identified by the various Business Units.

It is the intention to improve the administration of lease records and to maintain adequate, auditable documentation on leases.

It is to be noted that this particular issue does not represent a financial misstatement, as contended by the AG, but is rather a matter of appropriate disclosure in the financial statements.

4.6.2 GENERAL EXPENSES: HOUSING CONTRACTS

4.6.2.1 Limitation of scope: housing agreements not submitted

Since December 2006, management has implemented measures to improve the safeguarding of agreements and general record-keeping, such as routing the signed contract documents directly from the Executive Director's Office to the Archives Office to mitigate the risk of documents being misplaced.

4.6.2.2 Excess payments for work in progress

No excess payments in the amount of R5.3 million were made to contractors. This was explained in a response to an informal audit query. To date, the AG has not responded to indicate whether the response was satisfactory or not.

4.6.2.3 Contract, internal schedule and documentation discrepancies

Since December 2006, management has implemented measures to address the internal control weaknesses highlighted in the audit report. Measures such as comparing the housing contract value to value as per the letter of award, have been implemented as part and parcel of the project and contract reconciliations, which are firstly signed off by the financial and administration clerks and then by the Assistant Director : Housing and Land Finance.

6. EMPHASIS OF MATTER

6.1 INTERNAL CONTROL AND CONTROL ENVIRONMENT

Management understands and is committed to the maintenance of strong internal controls and a control environment that supports managers and all employees in adhering to the Municipality's financial policies and other legal obligations. The Municipal Manager has also instituted regular reporting by Executive Directors on the status of their intended actions to address internal control weaknesses, including an assessment of the extent to which internal controls are improving. The aforementioned reports are submitted on a monthly basis to Executive Directors meetings.

6.1.1 CONTROL WEAKNESSES NOTED

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

- (a) As permanent top management posts are filled, proper accountability for the risk assessment and management will be implemented, which will

form part of the incumbents' performance contracts. This KPA (risk management) is embedded in their contracts. The Municipal Manager will ensure compliance.

- (b) The concern is noted, and proper controls and monitoring mechanisms are now in place. Management has implemented procedures to reconcile these inventories as at 30 June 2007, and monthly thereafter.
- (c) Management will implement performance contracts for the appropriate levels of management.
- (d) Levels of authority are defined for categories of employees below Office Manager level, informed in part by the provisions of the Supply Chain Management Policy.

6.1.1.2 Implemented controls that had not functioned properly or were not adhered to at all times are listed below:

- (a) The segregation of duties regarding the Journal Management system has been implemented and has been functional since July 2006. A recent check confirmed that it is functional. Appropriate segregation of duties pertaining to the fuel stock system will be implemented.
- (b) – (d) The Audit findings relate to management's role in implementing internal controls, including internal and external audit recommendations. Internal Audit will continue to follow up with management regarding the implementation of recommendations and will report non-implementation to the Municipal Manager in the first instance. Internal Audit will also conduct follow-up audits to ascertain the extent of implementation of recommendations.

6.1.2 INTERNAL AUDIT

The continued staff shortages and the high number of forensic audits have impacted on the full implementation of the internal audit plan as envisaged.

The Internal Audit Division is in the interim concentrating on performing work in line with the plan and intends to outsource forensic audit work.

6.1.3 AUDIT COMMITTEE

Comment noted. The poor response to the advertisement for Audit Committee members and the associated selection of suitable members have delayed the establishment of the Committee.

6.2 EXPENDITURE

6.2.1 TENDERS: SUPPLY CHAIN MANAGEMENT

Management continually strives to improve the monitoring and control over the tender process.

6.2.1.1 Limitation of scope: access to database not provided

Firstly, in order to address the lack of access to original quotations, the IT Department will be requested to obtain access to the scanned images of the original quotes from TradeWorld. These images will then be linked and be made visible in electronic tender file format in the Informal Tender Scoring System (ITSS).

Secondly, access to view scanned images of the suppliers' CIPRO, BEE status and tax clearance certificate is available via the TradeWorld website. The delay in granting the AG access to the Supplier Database is regrettable. It is, however, the intention to address the issues raised.

It is to be noted that the AG was granted access, albeit after the cut-off date for the submission of the required information.

6.2.1.2 Non-adherence to Supply Chain Management Policy

- (a) A circular will be distributed to all Directorates, requesting that adequate reasons be furnished when tenders are awarded to contractors who did not score the highest points.
- (b) Clearance certificates relating to informal tenders are not archived in contract files. Tax/Billing Clearance certificate compliance relating to informal tenders below R200 000 is administered and archived by TradeWorld. If the supplier does not have a clearance certificate, that supplier's quoted price will not be made visible by TradeWorld to the Purchasing Office. The Purchasing Office will therefore not be able to award a contract to that supplier.

Formal tenders above R200 000 require the bidder to submit a tax clearance and a billing clearance as part of their tender documents. Non-inclusion of a clearance certificate will result in the bidder not being eligible for evaluation. Clearance certificates relating to formal tenders are archived in contract files by the Directorate responsible for the contract.

- (c) Regarding informal tenders below R200 000, TradeWorld has sole access to the original quotations; the Municipality is not able to verify whether or not the supplier has signed the quotation and relies on TradeWorld to ensure that quotations are signed by the suppliers. With formal tenders above R200 000, the Evaluation Committee is responsible for inspecting the tender documents for completeness.
- (d) Informal tenders rely on TradeWorld to determine the split between price and equity. Incomplete preference points scoring fields are being forward to the Municipality by TradeWorld.

In formal tenders, the split between price and equity is determined prior to the opening of the tender. The FTSS requires the Specifications Committee to enter the scoring criteria prior to the opening of the tender.

Once the tender has been opened to the public, the scoring criteria cannot be edited. At the close of the tender, the Evaluation Committee inputs the bidder's price and equity status. The FTSS then uses the PPPFA scoring criteria created by the Specifications Committee, together with the price and equity status entered by the Evaluation Committee, to score the tender. It is not possible to edit the scored tender.

- (e) A circular will be distributed to all Directorates, requesting that adequate reasons be furnished when tenders are awarded to contractors who were not recommended at evaluation.
- (f) As reflected in 6.2.1.2 (c) above, TradeWorld has sole access to the original quotations; with the result that the Municipality is not able to verify whether or not the supplier has submitted all the required tender documentation. With formal tenders above R200 000, the Evaluation Committee is responsible for inspecting the tender documents for completeness.

6.2.1.3 Formal tender scoring system

The Formal Tender Scoring System (FTSS) was not designed as a financial system with links to the general ledger, but rather as a management tool to assist the Supply Chain Management Unit with the scoring of formal tenders and to keep track of the status and progress of all formal tenders.

- (a); (d) and (e) The FTSS allows the user to input the requisition number, directorate and contract number. The FTSS also enables the user to upload the specifications and evaluation document.
- (b) The Supply Chain Management Unit will reconcile the approved tenders with the orders placed with the suppliers.
- (c) The Specifications Committee will ensure that all fields on the FTSS are correctly completed and that the specification document is uploaded.

- (f) The FTSS initially allowed the user to manually input a sequential tender number. The system was enhanced in June 2006 to automate the generation of the sequential numbering of tenders.

6.2.2 EMPLOYEE-RELATED COSTS

6.2.2.1 Poor administration and record-keeping within the Human Resources Business Unit

Apart from challenges that the organisation still faces in securing adequate space to keep personnel files at a central point, notable improvements have been implemented since October 2006. Improvements are, inter alia, in relation to the safe-keeping of documentation relating to new appointments (a template or checklist has subsequently been designed and implemented to rectify shortcomings in this area), that evidence of qualifications is placed on file and general improvements in record-keeping, e.g. leave records, allowances paid, etc. At the same time, the organization, through the review of its recruitment processes and practices, is planning to institute a mechanism for the verification of incumbents' qualifications before appointments are concluded. Relating to instances of allegations of misrepresentation of educational qualifications, the Internal Audit Sub-Directorate of the Municipality is finalising investigations in this regard.

6.2.2.2 Leave pay accrual

Leave records are being audited and updated to ensure reliability. The enhanced reliability of the leave records will result in a more accurate leave pay accrual.

6.3 WATER UNACCOUNTED FOR

The following actions are being taken to reduce unaccounted for water:

- **Replacement of Old Domestic Meters**

A programme to replace 27 000 of the old PE meters started in April 2006. Since July 2006, 16 595 water meters have been replaced at a cost of R3,97 million, with a saving of 28 700 kl of water that was underrecorded previously. This previously unbilled water is now accounted for and will reduce unaccounted for water. This programme will also be rolled out to the rest of the city.

- **Replacement of Large Diameter Industrial Meters**

Large water meters serving commercial and industrial consumers have been replaced and the programme to replace them at a two-yearly interval is in place. This is necessary as these consumers are the highest water user per connection and it is therefore imperative that these meters record the amount of water used accurately.

- **Billing**

Investigations have revealed that certain parts of the city are not being billed; approximately 20 000 water meters are not on the system. The affected sites have been identified on a GIS map. Aspects such as the integration between the current and previous three individual billing systems are being addressed. A plan to address these gaps will be discussed at the next Water Task Team meeting on unaccounted for water.

- **Metering of communal standpipes**

There are approximately 300 communal standpipes throughout Nelson Mandela Bay. Of these, 77 have now been metered and a plan is in place to meter the remainder.

- **Leakage Management in KwaZakhele and New Brighton**

A contract has been awarded for 4 200 existing unmetered connections to be metered. To date 2 303 connections have been installed.

- **Shared Toilets Project**

Unmetered and shared toilet water connections are being separated by the shared toilet project. Currently, 1 021 metered connections have been installed out of a project total of 2 400.

6.4 DEBTORS

6.4.1 COLLECTION OF OUTSTANDING DEBT

Management acknowledges that the 'collection period' target is not being met. However, the collections rate has improved from 89% in 2003/04 to 97% in 2005/06, due to much more aggressive collection efforts. The continuing consistent enforcement of collection practices will ensure that the Municipality meets its revenue collection targets. Progress towards achieving the target days has been made during the current financial year, but the target will, however, only be achieved if payment for municipal services remains above 100%.

6.4.2 HOUSING PENALTIES NOT CHARGED IN TERMS OF CONTRACTS ENTERED INTO

With the awarding of contracts to emerging contractors, it was not possible to charge penalties in view of doubts regarding the recoverability of the debt. Accordingly, the Housing and Land Business Unit adopted a process of contract termination, which has been implemented since December 2006.

In order to comprehensively respond to the audit finding, the Auditor-General should provide the supporting documentation for the penalties in the amount of R27,5 million.

6.4.3 ASSESSMENT OF DEBTORS

The Municipality had a provision for doubtful debts of R626 million as at 30 June 2006, compared to the total outstanding debtors' accounts of R1,164 billion. Management is of the view that the provision (approximately 54% of outstanding debtors) is more than adequate, irrespective of the scientific calculation thereof. For the 2006/07 Annual Financial Statements, management intends reviewing the basis used to calculate the provision, including the AG's recommendations, in order to determine if it would result in a more accurate provision.

6.5 ASSET MANAGEMENT

6.5.1 BANK BALANCES AND CASH

It is acknowledged that there are certain long outstanding reconciling items, and a concerted effort is presently being made to clear these items.

The statement by the Auditor-General that "the reconciliation was also prepared using cumulative figures, for example, amounts reimbursed represent the total of all reimbursements processed since the introduction of the stores and creditors system" is, however, not understood as the reconciliation of a balance sheet item including the balance carried over from one financial year to another and is, therefore, cumulative.

Management intends discussing the issue further with the AG's representatives to obtain a common and detailed understanding of the issue, and will make changes, if required.

6.5.2 INVENTORY MOVEMENTS NOT RECORDED IN CORRECT PERIOD

The necessary corrective measures will be implemented.

6.5.3 VEHICLES

While each Directorate is responsible for the management and supervision of the vehicles leased from Fleet Management Services, the Infrastructure and Engineering Directorate has identified the need for a corporate and co-ordinated approach to the management of the municipal fleet, in order to address the issues raised, as well as other issues such as improved productivity and vehicle abuse. To assist Directorates in the monitoring and management of their fleet, as well as to allow Fleet Management Services the ability to co-ordinate the use of vehicles, the Municipality has embarked on implementing:

- A Fleet Management Information System, which will be operational from 1 July 2007. The tender for this project was awarded by the Adjudication Committee on 23 March 2007.
- A Vehicle Monitoring System (tracking system), which will be operational from 1 July, 2007. The tender for this project was awarded by the Adjudication Committee on 19 April 2007.
- A Fuel Management System, which will monitor the fuel usage of the fleet. The tender for this project was awarded by the Adjudication Committee on 23 March 2007.

In addition to the above measures, the Executive Mayor has approved the establishment of a Fleet Monitoring Committee, which will address matters such as those raised by the AG. Every Directorate is represented on this Committee by a Director(s). A meeting of the Fleet Monitoring Committee will be held on 3 May 2007, where this issue will also be discussed to ensure that solutions are implemented.

6.6 IRREGULAR AS WELL AS FRUITLESS AND WASTEFUL EXPENDITURE

Management has developed and implemented formal procedures to ensure that all such instances are reported to the relevant offices and the necessary action is taken. It is also the intention to disclose it in the 2006/07 Financial Statements.

6.7 POTENTIAL FOR FRAUD

- (a) The Anti-fraud and Anti-corruption Policy has been implemented, but not updated. This will be done during 2007.
- (b) The relevant Directorates will be tasked to institute corrective measures to address the major internal control weaknesses.
- (c) Critical vacancies are being filled, depending on budget availability.
- (d) The comments are noted.
- (e) The Audit Committee has been functioning effectively since its establishment. With the filling of posts, Internal Audit should be able to meet its mandate of providing assurance on the internal controls, risk management and governance processes.
- (f) – (h) It is considered that measures have been implemented by management to mitigate the risks.

6.8 ENVIRONMENTAL, SUSTAINABLE DEVELOPMENT, AND OCCUPATIONAL HEALTH AND SAFETY ISSUES

Motherwell Canal: Consultants have been commissioned for the design and installation of mechanical screens in the canal. Reed beds will be installed at the foot of the canal to intercept any possible spillages entering the Swartkops River. The procedure for the monitoring and reporting of spillages has been updated.

Walmer Township: The lack of alternative land to which the households can be relocated is hampering this project. Regular monitoring of the site for gas emissions is being undertaken. This matter was recently reported to the Housing and Land Committee.

Internal audit involvement: The current audit plan provides for environmental audits to be conducted. Internal Audit currently participates in the Environmental Steering Committee meetings to understand/identify the areas of risk for control testing and to ensure legal compliance.

North End Lake pollution: From the data that is available, it has been determined that the area is not suitable for contact recreation. In terms of the 2010 process, a Spatial Planning and Environmental Technical Task Team will identify all the planning and environmental issues that need to be taken into account with regard to the upgrading of facilities around the lake. This will also include water quality issues. Some additional funding will also be applied for from DEAT. Water samples are being taken on a regular basis.

Swartkops River pollution: The audit finding is accepted. Numerous attempts have been made by the Department of Water Affairs and Forestry (DWAF) to remove alien vegetation along the Swartkops River. A resolution was taken that a Swartkops River Forum be established, whose aim will be to primarily focus on the effects of pollution in the river, in consultation with DWAF.

Sewage leaks into natural water systems: The Baakens River: Pipeline tracking inspections are now carried out regularly in this area to monitor potential spillage locations. Corrective measures are being taken.

Hlalani Settlement (Soweto-on-Sea): The Soweto-on-Sea/Veeplaas area is part of the **Zanemvula Project**, which is a national project. The project is being driven by the National and Provincial Departments of Housing and the Municipality. The business plan has already been approved, and this includes the upgrading of the entire Soweto-on-Sea area, as well as the relocation of the 2 900 people who are living below the floodplain to other areas in the Municipality, in particular Chatty 3 and 4, which is the relocation area. The first 300 relocations from the flood-plain area have been undertaken and before the end of the financial year, a further 600 relocations will take place. A transitional relocation area has been established, which will take another 250 families out of the floodplain area. Some of the challenges that need to

be dealt with are, firstly, to demarcate the floodplain area and, secondly, to physically demarcate the floodplain area on the ground so as to prevent the re-establishment of shacks along the floodplain area.

Waste Issues

- Soweto-on-Sea is serviced by Cocisizwe Cooperative, one of the Waste Management Division's contracted cooperatives.
- The cooperative is responsible for rendering a weekly kerb-side removal service and a cleansing service, i.e. litter picking and removal of illegal dumping.
- An anomaly has been noted in the removal of waste, i.e. due to difficult access the cooperative has not been rendering an effective service with regard to the collection and removal of illegal dumping.

The following actions have since been taken to improve the situation:

- Review of the current collection points in order to improve the retrieval rate of waste.
- Focus on the cleansing service, i.e. litter picking, as machinery cannot be used to remove illegal dumping.
- Engagement of the community in order to create awareness regarding the impact of improper waste management.

Although the above measures are currently being undertaken, it should be noted that the communities residing within this flood area will soon be relocated within the current financial year as part of the Zanemvula Project (a combined national, provincial and local government funded project). The area will be properly cleaned and rehabilitated as part of the project.

Waste Water Conveyance

The area is currently being serviced. The services in this area are also dependent on progress with the Housing delivery programme. Water samples are also to be taken from the Chatty River.

6.9 MUNICIPAL ENTITIES

In relation to the irregular expenditure, the Mandela Bay Development Agency instituted corrective measures by cancelling the contract originally awarded, at no cost to the agency.

The audit findings in relation to Feathermarket Promotions, Centenary Promotions and Nelson Mandela Metropolitan Art Museum will primarily be addressed in the 2006/07 Financial Statements.