

Report of the Auditor-general



TO THE COUNCIL OF THE BUFFALO CITY MUNICIPALITY
ON THE CONSOLIDATED ANNUAL FINANCIAL STATEMENTS OF BUFFALO CITY MUNICIPALITY FOR THE YEAR ENDED 30 JUNE 2006

1. AUDIT ASSIGNMENT

The consolidated financial statements as set out on pages 50 to 119, 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, read with sections 4 and 20 of the Public Audit Act, 2004 (Act No. 25 of 2004) and section 126(3) of the Municipal Finance Management Act, 2003 (Act No. 56 of 2003) (MFMA). These consolidated financial statements are the responsibility of the accounting officer. My responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free of material misstatement.

An audit includes:

- examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements
- assessing the accounting principles used and significant estimates made by management
- evaluating the overall consolidated 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.

4. QUALIFICATION

My concerns below are primarily as a result of the municipality's state of readiness, which was not at the desired level to implement and comply with the new accounting framework partly due to the municipality's initial position that these frameworks, as prescribed by National Treasury, was not applicable for the year under review.

Management has an obligation to put in place controls to help it identify and implement the appropriate accounting frameworks and policies to structure and govern its financial management responsibilities, as required by the MFMA. Management is also required to properly analyse financial risk at account balance level and implement appropriate controls to minimise these risks. During my audit I noted instances where management was not able to implement adequate controls, leading to material misstatement of the financial position of the municipality or where my scope was limited, despite my attempts to undertake alternative audit procedures. These instances of inadequate controls have been included in the paragraphs below.

4.1 Lack of supporting documentation

The non-submission of requested information is in contravention of section 74(1) of the MFMA, which states that the accounting officer must submit to the Auditor-General such information, returns, documents, explanations and motivations as may be prescribed or as may be required. The following are instances of non-submission:

a) General journals

General journals to the value of R96 284 008 submitted for audit purposes did not have adequate and appropriate documentation to support the transactions that they represented. This is as a result of ineffective reviewing, checking and reconciling of source documentation.

Consequently, it was not possible to obtain all the information and explanations that were considered necessary to gain assurance as to the validity, accuracy and completeness of account balances and classes of transactions as contained in the annual financial statements.

b) Capital commitments

Capital commitments to the amount of R473 905 507 are disclosed in note 32 to the annual financial statements. However, a complete list of signed contracts in support of this amount could not be provided as the municipality does not maintain a centralised register to manage the contracts. Furthermore, contract documents to the value of R2 370 243 could not be provided for audit purposes. Consequently, the completeness, validity and accuracy of capital commitments and related expenditure incurred in respect of these contracts cannot be verified.

4.2 Fixed assets

In terms of section 95(b) of the MFMA, the accounting officer should ensure that full and proper records of the financial affairs of the entity are kept. However, adequate control was not exercised over assets during the year under review. This is a result of asset records not being continuously and effectively monitored by management. The asset register is therefore not adequately maintained and supporting documentation relating to assets was found to be inaccurate and incomplete. In addition, no impairment tests have been conducted on fixed assets as required by GAMAP 17: Property, plant and equipment.

In the absence of adequate fixed asset records, it was not possible to verify the valuation, accuracy and completeness of assets of the municipality to the value of R1 044 898 347, as disclosed in the statement of financial position. This includes R610 579 892 in respect of infrastructure assets and R251 300 385 for land and buildings, the existence of which I could also not verify.

Management has addressed these concerns by adopting a three year plan to prepare and fully implement adequate records for infrastructure assets as disclosed in note 10 to the annual financial statements.

4.3 Accounts payable

Accounts payable are reflected in the statement of financial position at an amount of R77 761 159. In terms of GRAP 1: Presentation of financial statements, the municipality should prepare its financial statements on an accrual basis of accounting. Invoices pertaining to the 2006 year-end were only processed after year-end and, due to inadequate suppliers' reconciliations and monitoring, this was not detected by management. The total amount by which the above balance is understated could not be determined.

4.4 Employee costs

- a) The leave records on the personnel system were used as the basis for calculating the R35 059 919 leave accrual disclosed in note 7 to the consolidated annual financial statements. However, leave records for Buffalo City Municipality were found to be inadequate, since these records had not been regularly updated or do not exist and leave forms were not timeously filed. The municipality have implemented controls to ensure that adequate records are maintained, however these controls were only operational for the last 3 months of the year. In the absence of reliable leave records for the entire year under review, it was not possible to verify the accuracy, validity and completeness of the leave accrual.
- b) The leave pay accrual had not been discounted to its present value as required by IAS 19: Employee benefits. The financial misstatement in this regard is unknown as the municipality would have to determine an adequate discount rate in accordance with their risk profile, and the discounting period, if not known, would have to be estimated.
- c) There is no accounting policy to recognise the municipality's liability for the defined benefit plan in respect of post-employment benefits as required by IAS 19: Employee benefits. Accordingly, neither the liability for post-employment benefits nor the resulting actuarial gain/loss has been recognised in the consolidated annual financial statements. The total misstatement could not be determined in the absence of a policy and related information. The total amount of R75 700 000 in contributions' paid, as disclosed in note 34 to the financial statements, was expensed during the year in the statement of financial performance.

4.5 Government grants

In terms of IAS 20: Accounting for government grants and disclosure of government assistance, conditional government grants must be recognised as income only to the extent that there has been compliance with any conditions/restrictions attached to the grant. To the extent that the conditions/restrictions attached to a grant have not been met, the grant amount received must be deferred and presented as a liability in the statement of financial position and not as a reserve. A government grant reserve to the amount of R350 379 392 is disclosed in the statement of financial position. This should have been classified as a liability in the statement of financial position. Reserves are therefore overstated by R350 379 392 and liabilities is understated by the same amount.

4.6 Reserves

In terms of GRAP 1 Presentation of financial statements, paragraph 144, a municipality is not allowed to account for a reserve if it is not represented by cash or if there is no legislative requirement to account for the reserve. Included in the statement of financial position are reserves to the value of R142 251 984 which do not meet these requirements. In terms of GRAP 1: Presentation of financial statements the opening balance (R148 526 515) of these reserves should have been transferred to the opening balance of the accumulated surplus/(deficit), and the current year movement (R6 274 531) should have been expensed in the statement of financial performance. Reserves are therefore overstated by R142 251 984 and expenses are understated by R6 274 531.

4.7 Revenue and accounts receivable

In terms of paragraph 37 of GAMAP 9: Revenue, service charges revenue should be recognised when it is probable that the economic benefits would flow to the entity and the revenue can be measured reliably. This was not complied with as service charges for June 2006 in the amount of R37 681 128 were not recognised. However June 2005 service charges in the amount of R35 324 294 were recognised. As a result revenue is understated by R2 356 834 and accounts receivable is understated by R37681 128. Furthermore, accounts receivable has not been disclosed in terms of IAS 32: Financial instruments - disclosure and presentation.

4.8 Provisions

The carrying value of landfill sites as at 30 June 2006 is recorded in the fixed asset register at R47 244 281. No liability in respect of the obligation for restoring/rehabilitating these landfill sites has been raised as required by GAMAP 19: Provisions, contingent liabilities and contingent assets. The understatement of the liability could not be determined in the absence of management's assessment in this regard.

4.9 Inventory

The definition of inventory in terms of GAMAP 12: Inventory, paragraph 4, includes goods that are to be transferred at no charge or at a nominal charge. Paragraph 8 further states that such inventory must be valued at the lower of cost and current replacement cost. The inventory of housing stock meets this definition and management have estimated that the value of such stock is R4 948 995 for 30 June, 2006 and R6 603 000 for 30 June 2005. However, there is no policy in place to account for this inventory as management is of the view that these specific requirements of GAMAP 12 are not applicable to the municipality. As a result, inventory as disclosed in note 13 to the annual financial statements does not include inventories relating to housing stock. Consequently, inventory as disclosed in the statement of financial position is understated by an undetermined amount.

5. ADVERSE AUDIT OPINION

In my opinion, because of the significance of the matters described in the preceding paragraphs and their effect on the consolidated financial statements, the consolidated financial statements of the municipality do not present fairly, in all material respects, the financial position of the entity at 30 June 2006 and the results of its 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 paragraph 3, and in the manner required by the MFMA.

6. EMPHASIS OF MATTER

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

6.1 Basis of accounting

The municipality must prepare 'consolidated financial statements in accordance with the basis of accounting determined by the National Treasury, as described in paragraph 3. GRAP 1: Presentation of financial statements requires the basis of preparation of the consolidated financial statements to be disclosed in the consolidated financial statements. The entity has not complied with this disclosure requirement.

6.2 Material financial statement adjustments

Material changes had to be made to the consolidated financial statements as a result of audit findings and these statements were subsequently re-signed on 4 December 2006. Although I thereafter provided a further opportunity to the municipality to make additional changes to the financial statements based on my audit findings, to the extent possible and practical, the municipality opted not to do so due to a lack of available resources at the time.

7. APPRECIATION

The assistance rendered by the staff of Buffalo City Municipality and Buffalo City Development Agency during the audit is sincerely appreciated.



P. Bhana
for Auditor-General
East London • 20 December 2006



AUDITOR-GENERAL

Addendum to the Report of the Auditor-General on the Consolidated Financial Statements

TO THE COUNCIL OF THE BUFFALO CITY MUNICIPALITY FOR THE YEAR ENDED 30 JUNE 2006

BASIS OF PREPARATION

The consolidated financial statements have been prepared in accordance with the Standards of Generally Recognised Accounting Practices (GRAP) and the Standards of Generally Accepted Municipal Accounting Practices (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; and
- General Notice 992 of 2005, issued in Government Gazette no. 28095 of 15 December 2005.

The standards comprise of 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 Asset

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 are based on the South African Statements of Generally Accepted Accounting Practices (GAAP) including any interpretations of such Statements issued by the Accounting Practices Board.

Consideration of the Report of the Auditor-general

ON THE FINANCIAL STATEMENTS OF THE BUFFALO CITY MUNICIPALITY FOR THE YEAR ENDED 30 JUNE 2006

The Speaker invited the Chairperson of the Audit Committee, Mr. C. Guest, to elaborate on the report, which he duly did.

The Municipal Manager proposed the inclusion of two additional recommendations as set out in paragraphs (4) and (5) hereunder and the Council agreed thereto.

Councillor Rens made reference to a workshop held towards the end of the previous year by consultants, on how to read and interpret the Financial Statements. She expressed the opinion that some of the qualifications were “unfair” to the Council as it appeared that the goal posts were moved in approximately October 2006.

Continuing, Councillor Rens proposed that the Audit Committee submits a report to the Council by the end of March 2007, outlining the progress being made in implementing the steps required to rectify the qualifications on the audit.

Councillor Matika, in concurring with Councillor Rens, proposed that the report be submitted quarterly. He also proposed that the Municipal Manager investigates ways of capacitating the staff complement in the Internal Audit Unit to enable them to anticipate/foresee problems and not to wait for the presentation of financial statements to identify problem areas, as it was his understanding that their set-up was such that they are supposed to be “watchdogs” for the Council.

Councillor Matika further proposed that the Executive Mayor, in consultation and liaison with the Municipal Manager, investigates the possibility of setting up an Oversight Committee of the Council to deal with issues revolving around Terms of Reference of Committees, the outcome of which is to be submitted in the form of a report to the next meeting of the Council.

Councillors Dikimolo and Fritz seconded Councillor Matika’s proposals.

Councillor Mdyolo, in concurring with the proposal for quarterly reports from the Audit Committee, stated that an Audit Committee was not a crisis committee, but rather a monitoring or advisory committee and also seconded Councillor Matika’s proposals.

RESOLVED:

1. That the Council NOTES the comments of Management on the report of the Auditor-General on the Consolidated Financial Statements of Buffalo City Municipality for the period ended 30 June 2006, as set out in the report of the Municipal Manager attached as an Annexure to Report No. 3 of the Audit Committee to the Council meeting held on 30 January 2007, and ADOPTS them as the Council’s official comments.
2. That the Council gives consideration to adopting a structured communication strategy intervention to manage the content and impact of the report of the Auditor-General in order to ensure that investor, community and stakeholder confidence in the overall financial management of the city is maintained.
3. That management, the Office of the Auditor-General and the Audit Committee interact via a formal ongoing working group whose sole terms of reference will be to prevent a repeat of the adverse audit opinion received.
4. That the comments as contained in Report No. 3 of the Audit Committee under the above heading to the Council meeting held on 30 January 2007 and the report of the Municipal Manager to the Audit Committee meeting held on 18 January 2007, attached as an annexure to the abovementioned report, be conveyed to the Auditor-General, the MEC for Finance, the MEC for Local Government, Housing and Traditional Affairs and National Treasury.
5. That Report No. 3 of the Audit Committee under the above heading to the Council meeting held on 30 January 2007, together with the report of the Municipal Manager to the Audit Committee meeting held on 18 January 2007, attached as an Annexure to the aforementioned report, be incorporated into the Annual Report of the Council for the financial year ended 30 June 2006.
6. That the Audit Committee submits quarterly reports to the Council detailing progress made in respect of the implementation of steps to correct the adverse audit opinion received.

Report of the Audit Committee

CONSIDERATION OF THE REPORT OF THE AUDITOR - GENERAL ON THE FINANCIAL STATEMENTS OF THE BUFFALO CITY MUNICIPALITY FOR THE YEAR ENDED 30 JUNE 2006.

INTRODUCTION

The Auditor - General has completed his audit of the financial position of the Municipality for the financial year ended 30 June 2006.

The Audit Committee considered the report of the Auditor – General read together with the comments of Management on the Report of the Auditor - General. Copies of the reports considered by the Audit Committee are attached hereto as Annexures A and B.

Following consideration of both reports the committee submits its report as follows:

The Committee takes cognizance of the fact that the conversion to new accounting standards is a process and believes that the actions of the Chief Financial Officer to ensure compliance should be noted. The content and impact of the circular of the Accountant General dated 4 October 2006 is noted and the committee encourages management to examine closely the accounting standards with a view to ensuring compliance therewith as a matter of urgency.

The committee recognises that the implementation of the fixed assets register is a complex issue being dealt with in terms of a three year “road map” but urges management to further engage with the Auditor – General and to obtain clarity from the Accountant – General’s office regarding the differences of opinion on the content and format of the register.

With regard to the omission of certain accounts payable in the financial statement the Committee takes note of the importance of setting of cut off dates, but nevertheless believes that the current policy should be aligned with the accounting standard and urges that all efforts be made to comply therewith.

Incremental steps were undertaken to improve the accuracy of the leave records during the financial year. However, the committee urges that management interact with the Auditor -General regarding the implications of IAS 19 [Employee benefits including post retirement benefits] and that thereafter the required accounting policy be prepared and implemented in compiling the 2007 financial year statements.

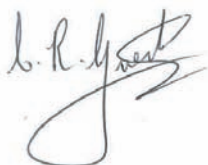
Urgent clarity also requires to be sought from National Treasury regarding the technical accounting treatment of Government Grants and Reserves as well as inventory and the committee urges management to obtain such clarity without delay in order that these matters can be cleared well ahead of the end of the 2006/7 financial year.

The issue of the basis of recognition of income (accounts receivable) is set out in the relevant accounting standard and should be duly complied with by management in future.

Given the foregoing, and taking note of the serious nature of the adverse audit opinion, arising from both substantive and technical issues, management is urged to implement every possible effort to and to undertake those actions that will avoid a repetition.

The Audit Committee accordingly **RECOMMENDS**:

1. That the Council notes the comments of management on the Report of the Auditor - General on the Consolidated Financial Statements of the Buffalo City Municipality for the period ended 30 June 2006 and adopts them as the Council’s official comments.
2. That Council considers adopting a structured communication strategy intervention to manage the content and impact of the report of the Auditor - General in order to ensure that investor, community and stakeholder confidence in the overall financial management of the city is maintained.
3. That management, the Office of the Auditor – General and the Audit Committee interact via a formal ongoing working group whose sole terms of reference will be to prevent a repeat of the adverse audit opinion received



C.R. GUEST.
CHAIRPERSON: BUFFALO CITY AUDIT COMMITTEE.

(Scanned signature inserted with approval)

