

**REPORT OF THE AUDITOR-GENERAL TO THE COUNCIL OF THE BUFFALO CITY MUNICIPALITY AND THE EASTERN CAPE PROVINCIAL LEGISLATURE ON THE GROUP FINANCIAL STATEMENTS AND PERFORMANCE INFORMATION OF THE BUFFALO CITY MUNICIPALITY FOR THE YEAR ENDED 30 JUNE 2007**

**REPORT ON THE FINANCIAL STATEMENTS**

**Introduction**

1. I have audited the accompanying group financial statements of Buffalo City Municipality which comprise the statement of financial position as at 30 June 2007, statement of financial performance, statement of changes in net assets and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes, and the accounting officer's report, as set out on pages [xx] to [xx].

**Responsibility of the accounting officer for the financial statements**

2. The accounting officer is responsible for the preparation and fair presentation of these financial statements in accordance with the basis of accounting determined by the National Treasury, as set out in accounting policy note 1 and in the manner required by the Local Government: Municipal Finance Management Act, 2003 (Act No. 56 of 2003) (MFMA). This responsibility includes:
  - designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error
  - selecting and applying appropriate accounting policies
  - making accounting estimates that are reasonable in the circumstances.

**Responsibility of the Auditor-General**

3. As required by section 188 of the Constitution of the Republic of South Africa, 1996, read with section 4 of the Public Audit Act, 2004 (Act No. 25 of 2004), my responsibility is to express an opinion on these financial statements based on my audit
4. I conducted my audit in accordance with the International Standards on Auditing. Those standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.
5. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but

not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

6. An audit also includes evaluating the:
  - appropriateness of accounting policies used
  - reasonableness of accounting estimates made by management
  - overall presentation of the financial statements.
7. Paragraph 11 et seq. of the Statement of Generally Recognised Accounting Practice, GRAP 1 *Presentation of financial statements* requires that financial reporting by entities shall provide information on whether resources were obtained and used in accordance with the legally adopted budget. As the budget reporting standard is still in the process of being developed, I have determined that my audit of any disclosures made by Buffalo City Municipality in this respect will be limited to reporting on non-compliance with this disclosure requirement.
8. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

#### **Basis of accounting**

9. The municipality's policy is to prepare financial statements on the basis of accounting determined by the National Treasury, as set out in accounting policy note 1.

#### **Basis for qualified opinion**

##### **Property, plant and equipment**

10. Paragraph 15 of GAMAP 17: Property, plant and equipment requires that, where appropriate, the total expenditure on an asset should be allocated to its component parts and account for each component separately, specifically where the assets have different useful lives or provide benefits to the entity in a different pattern, thus necessitating the use of different depreciation rates and methods. Management is in the process of updating the asset register and accompanying records with regard to infrastructure assets and heritage assets as disclosed in note 10 to the annual financial statements. In the absence of such records it was not possible to verify the existence and completeness of infrastructure assets of R546,3 million and heritage assets of R559 356 as disclosed in the annual financial statements.

Furthermore, the municipality expensed all items of property, plant and equipment with a cost of R10 000 or less. Such assets should have been capitalised and depreciated over their estimated useful lives as required by GAMAP 17. Consequently the cost and accumulated depreciation of property, plant and equipment as disclosed in note 10 to the financial statements is understated by R2,8 million (2006: R3,6 million). In addition, the classification of expenditure between depreciation and general expenses is misstated by the same amount.

##### **Provision for the rehabilitation of landfill sites**

11. The entity has raised a provision and corresponding asset amounting to R119,4 million for the rehabilitation of landfill sites. Reliable supporting

documentation regarding the total amount included in the provision was not provided for audit purposes. It was therefore not possible to determine the correct valuation of the provision.

Furthermore, the retrospective treatment of the provision was not included in the 2005-06 figures of the annual financial statements as required by GRAP 3: Accounting policies, changes in accounting estimates and errors. Due to the lack of adequate supporting documentation I was unable to quantify the misstatement for the prior year.

### Investments

12. During the audit of investments a significant deviation was noted between the investment register, general ledger and bank confirmations/investment statements.

The difference was due to a ceded investment of R17,7 million having been omitted from the 2005-06 annual financial statements resulting in a prior period error. This error was not corrected retrospectively as required by GRAP 3: Accounting policies, changes in accounting estimates and errors, due to the uncertainty surrounding the contra entry. The comparative amount for investments in the statement of financial position was therefore understated by R17,7 million. However, this investment was corrected directly against the accumulated surplus and included in the 2006-07 investment closing balance at 30 June 2007.

### Qualified opinion

13. In my opinion, except for the effects of the matters described in the basis for qualified opinion paragraphs, the financial statements of Buffalo City Municipality and group as at 30 June 2007 and its financial performance and cash flows for the year then ended have been prepared, in all material respects, in accordance with the basis of accounting determined by the National Treasury as set out in accounting policy note 1 to the annual financial statements and in the manner required by the MFMA.

### Emphasis of matters

I draw attention to the following matters:

### Basis of accounting

14. As set out in accounting policy note 1, the National Treasury approved a deviation from the basis of accounting applicable to the municipality in terms of *General Notice 552 of 2007*, issued in *Government Gazette No. 30013 of 29 June 2007*.

| Standard no. | Standard title                                                  | GRAP, GAMAP and/or SA GAAP requirement(s), exempted in terms of <i>General Notice 552 of 2007</i> , issued in <i>Government Gazette No. 30013 of 29 June 2007</i> , that has/have been adopted early                       |
|--------------|-----------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| GRAP 3       | Accounting Policies, Changes in Accounting Estimates and Errors | <ul style="list-style-type: none"> <li>▪ Identification and impact of GRAP Standards that have been issued but are not yet effective (GRAP 3.30 – 31)</li> <li>▪ Changes to accounting policies (GRAP 3.14, 19)</li> </ul> |
| GAMAP 9      | Revenue                                                         | <ul style="list-style-type: none"> <li>▪ Initial measurement of fair value; discounting all future receipts using an imputed rate of return (GAMAP 9.12 and SAICA</li> </ul>                                               |

| Standard no.    | Standard title                                                           | GRAP, GAMAP and/or SA GAAP requirement(s), exempted in terms of <i>General Notice 552 of 2007</i> , issued in <i>Government Gazette No. 30013 of 29 June 2007</i> , that has/have been adopted early                                                                                                                                                                                                                                            |
|-----------------|--------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                 |                                                                          | using an imputed rate of return (GAMAP 9.12 and <i>SAICA circular 9/06</i> )                                                                                                                                                                                                                                                                                                                                                                    |
| GAMAP 12        | Inventories                                                              | <ul style="list-style-type: none"> <li>▪ The entire standard as far as it relates to immovable capital assets inventory that is accounted for in terms of GAMAP 17</li> <li>▪ The entire standard to the extent that it relates to water stock that was not purchased by the municipality</li> </ul>                                                                                                                                            |
| GAMAP 17        | Property, Plant and Equipment                                            | <ul style="list-style-type: none"> <li>▪ Review of useful life of items of PPE recognised in the financial statements (GAMAP 17.59 – 61, 77)</li> <li>▪ Review of depreciation method applied to PPE recognised in the financial statements (GAMAP 17.62, 77)</li> <li>▪ Impairment of non-cash generating assets (GAMAP 17.64 – 69, 75(e)(v) – (vi))</li> <li>▪ Impairment of cash generating assets (GAMAP 17.63, 75(e)(v) – (vi))</li> </ul> |
| IAS 11 (AC 109) | Construction Contracts                                                   | <ul style="list-style-type: none"> <li>▪ Entire standard</li> </ul>                                                                                                                                                                                                                                                                                                                                                                             |
| IAS 14 (AC 115) | Segment Reporting                                                        | <ul style="list-style-type: none"> <li>▪ Entire standard</li> </ul>                                                                                                                                                                                                                                                                                                                                                                             |
| IAS 17 (AC 105) | Leases                                                                   | <ul style="list-style-type: none"> <li>▪ Recognising operating lease payments/receipts on a straight-line basis if the amounts are recognised on the basis of the cash flows in the lease agreement (IAS 17.33 – 34 and 50 – 51, <i>SAICA circular 12/06.8 – 11</i>)</li> </ul>                                                                                                                                                                 |
| IAS 19 (AC 116) | Employee Benefits                                                        | <ul style="list-style-type: none"> <li>▪ Defined benefit accounting as far as it relates to defined benefit plans accounted for as defined contribution plans and the defined benefit obligation disclosed by narrative information (IAS 19.29, 48 – 119 and 120A(c) – (q))</li> </ul>                                                                                                                                                          |
| IAS 20 (AC 134) | Accounting for Government Grants and Disclosure of Government Assistance | <ul style="list-style-type: none"> <li>▪ Entire standard excluding paragraphs 24 and 26, replaced by GAMAP 12.8, GAMAP 17.25 and GAMAP 9.42 – 46.</li> </ul>                                                                                                                                                                                                                                                                                    |
| IAS 36 (AC 128) | Impairment of Assets                                                     | <ul style="list-style-type: none"> <li>▪ Entire standard</li> </ul>                                                                                                                                                                                                                                                                                                                                                                             |
| IAS 38 (AC 129) | Intangible Assets                                                        | <ul style="list-style-type: none"> <li>▪ The entire standard except for the recognition, measurement and disclosure of computer software and website costs (SIC 32) and all other costs are expensed</li> </ul>                                                                                                                                                                                                                                 |
| IAS 39 (AC 133) | Financial Instruments: Recognition and Measurement                       | <ul style="list-style-type: none"> <li>▪ Initially measuring financial assets and liabilities at fair value (IAS 39.43, AG 79, AG 64 – AG 65 and <i>SAICA circular 9/06</i>)</li> </ul>                                                                                                                                                                                                                                                         |
| IAS 40 (AC 135) | Investment Property                                                      | <ul style="list-style-type: none"> <li>▪ The entire standard to the extent that the property is accounted for in terms of GAMAP 17</li> <li>▪ Disclosure of the fair value of investment property if the cost model is applied and where the municipality has recognised the investment property in terms of this standard (IAS 40. 79(e)(i) – (iii))</li> </ul>                                                                                |
| IFRS 3 (AC 140) | Business Combinations                                                    | <ul style="list-style-type: none"> <li>▪ Entire standard</li> </ul>                                                                                                                                                                                                                                                                                                                                                                             |
| IFRS 5 (AC 142) | Non-current Assets Held for Sale and Discontinued Operations             | <ul style="list-style-type: none"> <li>▪ Classification, measurement and disclosure of non-current assets held for sale (IFRS 5.6 – 29 (in so far as it relates to non-current assets held for sale) and 38 – 42)</li> </ul>                                                                                                                                                                                                                    |
| IFRS 7 (AC 144) | Financial Instruments: Disclosures                                       | <ul style="list-style-type: none"> <li>▪ Entire standard to be replaced by IAS 32 (AC 125) issued in August 2006 and effective for financial statements covering periods beginning on or after 1 January 1998</li> </ul>                                                                                                                                                                                                                        |

15. As indicated in paragraph 10 above and as per note 10 of the financial statements, the municipality has commenced with the infrastructure asset componentisation. Adjustments to the accumulated surplus are affected in the current year as a result of this componentisation and consequent differences in residual values and estimated useful lives of the individual components compared to the assets stated in previous years.

## **OTHER MATTERS**

I draw attention to the following matters that are ancillary to my responsibilities in the audit of the financial statements:

### **Non-compliance with applicable legislation**

#### **Environmental Conservation Act, 1989 (Act No. 73 of 1989)**

16. The municipality has not complied with the permits' conditions which were legislated by the Environmental Conservation Act, 1989 (Act No. 73 of 1989) with respect to the East London Regional Waste Disposal site and King Williams Town Waste Disposal site.

Permit conditions such as methane gas monitoring and detection monitoring of water quality were not complied with during the year under review. There were no quality internal audit reports and no annual external audit reports as required by the permit for the King William's Town Waste Disposal site. Furthermore, quantity/type of waste and chemical information as required by annexures IV and V, respectively, of the permits had not been prepared or submitted to the regional director for both disposal sites.

Furthermore, in terms of part IV, section 20 of the above act no person may establish, provide or operate a disposal site without a permit issued by the minister and a person who wishes to provide a disposal site must apply for a permit on the prescribed form. During the audit it was noted that various disposal sites were in use, however, no evidence could be provided to ensure that a permit had been granted by the minister for the establishment, development and operation of these sites.

#### **Municipal Finance Management Act, 2003 (Act No. 56 of 2003)**

17. Non-compliance with the procurement procedures of the supply chain management policy has resulted in irregular expenditure to the value of R1,9 million. This was identified during the audit of capital commitments where there were several contracts on which the expenditure to date exceeded the council's approved resolution regarding the contract/project value. By inspecting the relevant contract files, it was identified that there were no additional supporting documentation to validate the authorisation of the excess payments or additional funding.

### **Material corrections made to the financial statements submitted for auditing**

18. The financial statements, approved by the accounting officer and submitted for auditing on 28 September 2007, have been significantly revised in respect of the following material misstatements identified during the audit:

- An amount was erroneously included in the disclosure of contingent liabilities amounting to R14 million.
- Long-term liabilities were incorrectly recognised as expenditure, resulting in long-term liabilities and expenditure being overstated by R6,3 million.
- The long-term liabilities were incorrectly recognised as sundry creditors, resulting in long-term liabilities being understated and sundry creditors overstated by R29,4 million.
- The current portion of long-term liabilities were not fully disclosed, resulting in it being understated and long-term liabilities overstated by R20,2 million.
- Bad debts were incorrectly written off directly against the accumulated surplus in the statement of changes in net assets instead of in the statement of financial performance, resulting in the surplus for the year and expenditure in the statement of performance being understated by R38,8 million
- Government grants (PPE) were overstated by R5,9 million and donations and public contributions (PPE) understated by the same amount.
- Debtors: electricity were incorrectly classified due to an incorrect coding on the system, resulting in the debtor: electricity being overstated and other service debtors being understated by R9 million.
- Disclosure note 14, consumer debtors, was not disclosed correctly, resulting in various changes with the following net effect:
  - i. Gross debtors were understated by R62,3 million (2005-06: R61,5 million) (disclosure note).
  - ii. Provision for impairment of accounts receivable was understated by R24,9 million (2005-06: R30,3 million) (disclosure note).
  - iii. Sundry ageing, note 14 – summary of debtors by service category was understated by R64 million (2005-06: R64,5 million).
  - iv. Summary of debtors by service category, note 14, was understated by R6,3 million for consumers (2005-06: R55 million), by R7,7 million (2005-06: R8,6 million) for industrial/commercial and by R13,6 million (2005-06: R16,3 million) for other.
- Disclosure note 15, other debtors was not disclosed correctly, resulting in the overstatement of other debtors by R39,7 million (2005-06: R11,7 million) .
- The provision for leave accrual was overstated and employee benefits expenditure understated by R2 million due to the incorrect report being run from the Payday system.
- The disclosure note 32 of capital commitments in respect of capital expenditure – approved and contracted for infrastructure, community and other was overstated by R122,7 million, R8,8 million and R11,2 million respectively. Commitments in respect of capital expenditure – approved but

not yet contracted for infrastructure, community and other respectively was understated by R122,7 million, R8,8 million and R11,2 million.

- The presentation and disclosure requirements of IAS 17: Leases, was omitted from the annual financial statement notes, resulting in the municipality amending the notes to include the relevant presentation and disclosure.
- The Provision for the rehabilitation of landfill sites have been adjusted by a further R56 million for sites that were not previously included in the calculation.
- A deferred income account was incorrectly created to eliminate the government grant reserve. Thus the accumulated surplus was understated and deferred income was overstated by R45 million (2006: R350,3 million). Furthermore note 8 “Deferred Income” was removed from the accounting policies.

### Internal control

19. Section 62(1)(c)(i) of the MFMA states that the accounting officer must ensure that the municipality has and maintains effective, efficient and transparent systems of financial and risk management and internal control. The paragraphs below depict the root causes of the matters indicated, as they relate to the five components of internal control. In some instances deficiencies existed in more than one internal control component.

| Reporting item                                                        | Control environment | Assessment of risks | Control activities | Information and communication | Monitoring |
|-----------------------------------------------------------------------|---------------------|---------------------|--------------------|-------------------------------|------------|
| <b>Basis for qualification opinion</b>                                |                     |                     |                    |                               |            |
| Property plant and equipment                                          |                     |                     |                    |                               | ✓          |
| Provision for the rehabilitation of landfill sites                    |                     |                     | ✓                  |                               |            |
| Investments                                                           |                     |                     | ✓                  |                               |            |
| <b>Emphasis of matter</b>                                             |                     |                     |                    |                               |            |
| Applicable basis of accounting – departures and deviations            |                     |                     |                    |                               | ✓          |
| <b>Other matters</b>                                                  |                     |                     |                    |                               |            |
| Non-compliance with applicable laws and regulations:<br>Environmental |                     |                     | ✓                  |                               |            |

| Reporting item                                   | Control environment | Assessment of risks | Control activities | Information and communication | Monitoring |
|--------------------------------------------------|---------------------|---------------------|--------------------|-------------------------------|------------|
| Conservation Act, 1989 (Act No. 73 of 1989)      |                     |                     |                    |                               |            |
| Non-compliance with applicable legislation: MFMA |                     |                     |                    |                               | ✓          |
| Material corrections to the financial statements |                     |                     |                    |                               | ✓          |

## OTHER REPORTING RESPONSIBILITIES

### Reporting on performance information

20. I have audited the performance information as set out on pages [xx] to [xx].

### Responsibility of the accounting officer for the performance information

21. In terms of section 121(3)(c) of the MFMA the annual report of a municipality must include the annual performance report of the municipality prepared by the municipality in terms of section 46 of the Local Government: Municipal Systems Act, 2000 (Act No. 32 of 2000) (MSA).

### Responsibility of the Auditor-General

22. I conducted my engagement in accordance with section 13 of the Public Audit Act, 2004 (Act No. 25 of 2004) read with *General Notice 646 of 2007*, issued in *Government Gazette No. 646 of 25 May 2007* and section 45 of the MSA.

23. In terms of the foregoing my engagement included performing procedures of an audit nature to obtain sufficient appropriate audit evidence about the performance information and related systems, processes and procedures. The procedures selected depend on the auditor's judgement.

24. I believe that the evidence I have obtained is sufficient and appropriate to provide a basis for the audit findings reported below.

### Audit finding

#### Adoption of the performance management system

25. During the audit of performance information it was determined that the performance management system (PMS) was recommended for adoption on 7 August 2007. The process of setting the key performance indicators (KPIs) and



the target was, however, started on 29 March 2007 when the IDP/budget and PMS Representative Forum meeting was held.

This indicated that the KPIs and the targets were set before the PMS was adopted by the council which is in contravention of the above legislation.

### **APPRECIATION**

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

Auditor-General

East London

12 December 2007

