

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

## **REPORT ON THE FINANCIAL STATEMENTS**

### **Introduction**

1. I was engaged to audit the accompanying financial statements of the Engcobo Municipality which comprise the statement of financial position as at 30 June 2007, statement of financial performance, statement of changes in net assets and consolidated and separate cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes, as set out on pages...to....

### **Responsibility of the [accounting officer/accounting authority] for the financial statements**

2. The accounting officer is responsible for the preparation and fair presentation of these financial statements in accordance with the standards laid down by the Institute of the Municipal Financial Officers in its Code of Practice for Local Government Accounting (1997) and the Published Annual Financial Statements for Local Authorities (2<sup>nd</sup> edition 1996, as amended), and in the manner required by the Local Government: Municipal Finance Management Act, 2003 (Act No. 56 of 2003) (MFMA), Auditor-General Audit Circular 1 of 2005. 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) [section of applicable legislation], my responsibility is to express an opinion on these financial statements based on my audit in accordance with the International Standards on Auditing. Because of the matters discussed in the Basis for disclaimer of opinion paragraphs, however, I was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

### **Basis of accounting**

4. The municipality's policy is to prepare financial statements on the basis of accounting determined by the National Treasury, in accordance with the standards laid down by the Institute of the Municipal Financial Officers in its Code of Practice for Local Government Accounting (1997) and the Published Annual Financial Statements for Local Authorities (2<sup>nd</sup> edition 1996, as amended) as set out in accounting policy note 1.

### **Basis for disclaimer of opinion**

#### **Funds and Reserves**

5. The revolving fund amounting to R623 442 as disclosed in the financial statements is not sufficiently backed by concomitant assets such as cash and

investments. The dedicated investment for revolving fund amounts to R69 343. Accordingly I could not verify the validity of the revolving fund.

Supporting documentation in respect of journals amounting to R199 384, processed in the accumulated surplus/deficit was not provided for audit purposes and as a result I could not confirm validity of transactions contained therein.

Supporting documentation in respect of expenses amounting to R100 000 incurred in the mayoral fund was not submitted for audit purposes and as a result validity and occurrence of these expenses could not be confirmed.

#### Fixed Assets

6. The accounting policy of Engcobo Municipality indicates that assets procured using advances will be depreciated in line with the capital redemption of the advances and loans. By way of this fixed assets are always equal to the capital amount of advances outstanding. There are advances amounting to R8, 3 million included in creditors acquired for the procurement of fixed assets. Accordingly assets have been understated by an undisclosed amount.

Additions to fixed assets amounting to R186 069.82 have not been recorded in the assets register of the municipality and as a result completeness of the assets register maintained by the municipality could not be confirmed.

During the verification process of assets in the assets register, existence of fixed assets amounting to R589 354 could not be confirmed and accordingly the valuation of assets disclosed in the financial statements could not be confirmed.

#### Accounts Receivable

7. The debtors ageing analysis submitted for audit purposes reflects a balance of R2,2 million whereas the financial statements in respect of current consumer debtors discloses an amount of R2,5 million in note 9 to the annual financial statements. Accordingly debtors have been understated by R242 355.

Supporting documentation as well as the basis of the provision for bad debts amounting to R1 million as disclosed in the annual financial statements could not be submitted for audit purposes and as a result I could not confirm the valuation of accounts receivable.

#### Investments

8. Investments totalling to R769 508 have not been included in the investment register of the municipality submitted for audit purposes. The investments of R9 .8 million as disclosed in the annual financial statements are therefore overstated by the same amount.

Bank confirmations confirm an amount of R9,8 million whereas the bank statements used in the preparation of bank reconciliations and cash book of the municipality reflect an investment balance of R9,7 million. Accordingly the bank account has been overstated by R332 552.

#### Cash and Bank

9. The municipality does not have a practice of clearing its suspense accounts timeously, consequently journals and other supporting documentation in respect of suspense account amounting to R846 579 were not produced at year end for audit purposes. Accordingly I was unable to determine the impact of the journal entries in the financials statements.

Stale cheques amounting to R1,3 million were written back at year end. Proof that journal entries were processed to adjust expenses and creditors could not be

produced for audit purposes. I was therefore unable to determine the impact of this in the annual financial statements disclosures.

Comparative figures of cash and bank of R1 million reflect an overdraft per note 20 of the financial statements. However the same note reflects a favourable balance as an opening balance of the current year. Accordingly the valuation of cash and bank could not be confirmed.

Bank confirmations confirm an amount of R146 413 whereas bank statements used in the preparation of bank reconciliations and cash book of the municipality reflect a balance of R502 029. Accordingly the bank account has been overstated by R501 572.

#### Provisions

10. Engcobo municipality has disclosed provisions amounting to R 111 559 in the financial statements submitted for audit purposes. However the municipality's legal advisors have confirmed legal claims amounting to R202 000. Furthermore a leave provision was not disclosed, and leave records were not properly maintained by the municipality and the leave register was incomplete. I could not confirm completeness of the provisions disclosed in the annual financial statements.

#### Accounts Payable

11. Monitoring controls such as reviews and reconciliations were not effective at Engcobo Municipality for the period under review, and as a result an amount of R8,3 million in respect of internal advances has been included in the creditors' amount of R9,6 million disclosed in the financial statements. Accordingly the creditors have been overstated by R8,3 million.

Supporting documentation in respect of Debit journal entries amounting to R662 409 and credit journal entries amounting to R174 217 processed through accounts payable were not submitted for audit purposes. I was thus unable to determine the impact of these journals in the accounting records as my scope was limited.

A creditors listing and creditors' sub-ledger detailing all individual creditors' balances were not maintained by the municipality for the period under review. Accordingly I could not satisfy myself as to the existence of obligations of the account balance of R9,6 million.

#### Value Added Tax

12. The VAT returns (VAT 201's) with an amount of R799 769 submitted for audit purposes did not agree with the amount of R1,8 million per the financial statements by R1 million.

#### Expenditure

13. The total amount of expenditure of R38,3 million as disclosed in the financial statements of Engcobo municipality, includes unauthorised journals amounting to R239 966 processed without supporting documentation.

#### Irregular expenditure

14. Payments amounting to R83 164 were made on quotations, and no invoices were submitted for audit purposes and no disclosure of this has been made in the financial statements.

## Unauthorised Expenditure

15. The municipality has overspent its expenditure budget by R442 754 and the over expenditure is therefore regarded as unauthorised. The unauthorised expenditure has not been appropriately disclosed in the annual financial statements.

### Disclaimer of opinion

16. Because of the significance of the matters described in the Basis for disclaimer of opinion paragraphs, I have been unable to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements of Engcobo Municipality. Accordingly, I do not express an opinion on the financial statements.

### Emphasis of matters

I draw attention to the following matter(s):

Going concern

17. The accounting officer's report on page 4 of the financial statements, indicates that Engcobo Municipality incurred a closing deficit of R2, 9 million for the year ended 30 June 2007 and as at that date, the municipality's total liabilities exceeded its total assets by R2 million. These conditions along with other matters, point to the existence of a material uncertainty that may cast significant doubt on the entity's ability to continue as a going concern.

### OTHER MATTERS

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

#### Internal control

18. 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 table below depicts the root causes of the matters indicated, as they relate to the five components of internal control. In some instances deficiencies exist in more than one internal control component.

Reporting item	Control environment	Assess of risks	Control activities	Information and Communication	Monitoring
Basis for disclaimer of opinion					
Provision on the disclosed does not agree to the financial statements			✓		
Unauthorised journals without supporting documentation					✓
Internal advance has been incorrectly included in the creditors					✓

amount					
Supporting documentation not submitted for audit purposes					✓
Accrual listing and creditors sub-ledger not provided for audit purpose					✓
Internal advance not supported by the assets					✓
Assets register not timeously updated					✓
Assets not included in the assets register					✓
VAT amount differ to the financial statements				✓	
Debtors amount differ to the financial statements				✓	
Basis of provision for bed debts could not be provided for audit purpose					✓
Investment register amount differ to the financial statements				✓	
Investment amount per the bank confirmation differ to the financial statements				✓	
Suspense account not timeously cleared					✓
No documentation supporting journals made for the stale					✓

cheques written back					
Cash and bank in the balance sheet does not agree to the note				✓	
Cash and bank amount per the bank statements differs with the bank confirmation				✓	
Concomitant assets does not exist for the funds held by the municipality					✓
Supporting documentation for journals were not provided for audit purposes					✓
Supporting documentation for expenditure relating to funds were no provided for audit purposes					✓
Irregular expenditure					✓
The municipality overspent its expenditure budget					✓
<b>Emphasis of matter</b>					
Municipality's total liabilities exceeded its total assets				✓	

Other Matters					
Unapproved overdraft facilities				✓	
Late submission of the financial statements					✓

#### Control environment

18. The municipality did not establish the key elements of a control environment to achieve sound financial management. This resulted in an inadequate level of skills and knowledge to enable the financial statements to be accurately prepared in accordance with the applicable basis of accounting, which in turn gave rise to the numerous qualifications concerning non-adherence to the accounting standards as well as many corrections to the financial statements resulting from matters identified.

#### Control activities

19. The effectiveness of control activities over business and accountancy processes was not adequate. This is evident from the reported matters relating to debt recovery, suspense account, bank reconciliations and the asset register.

#### Monitoring of controls

20. The monitoring of controls, such as the review of reconciliations, confirmations from external parties and the internal audit process, was not effective. This contributed to the reported matters relating to the recoverability of debtors and the completeness and accuracy of account balances. The internal audit division did not provide an effective service to management by assisting them in their governance responsibilities.

#### Material non-compliance with applicable legislation

21. Municipal Finance Management Act, No.56 of 2003; section 45(4)(a) and (b) provides that a municipality must pay off short term debt within the financial year; and may not renew or refinance short-term debts, whether its own debt or that of any other entity, where such renewal or refinancing will have the effect of extending the short-term debt into a new financial year. However the municipality did not have an approved overdraft facility and the overdraft totalling to R463 691 is disclosed in the financial statements.

The Municipal Finance Management Act, No.56 of 2003; section 126(1)(a) prescribes that the accounting officer of a municipality must prepare the annual financial statements of the municipality and, within two months after the end of the financial year to which those statements relate, submit the statements to the Auditor-General for auditing. However the financial statements of the municipality were submitted on the 04 October 2007, three months after year-end.

#### Matters of governance

22. The Municipal Structures act No.117 of 1998, section 18(2), provides that a municipal council must meet at least quarterly during the financial year; however during the current financial year the municipality did not comply with this section as only 2 council meetings were held according to the minutes of the meetings provided for audit purposes.

## **OTHER REPORTING RESPONSIBILITIES**

### **Reporting on performance information**

I was engaged to audit the performance information of Engcobo Municipality.

### **Responsibility of the accounting officer**

23. 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).

In terms of section 121(4) (d) of the MFMA, the annual report of a municipal entity must include an assessment by the entity's accounting officer of the entity's performance against any measurable performance objectives set in terms of the service delivery agreement or other agreement between the entity and its parent municipality.

### **Responsibility of the Auditor-General**

24. I conduct my engagements 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 Municipal Systems Act.

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

### **Audit findings**

25. Engcobo Municipality did not submit the performance information for the period under review, accordingly performance information of Engcobo municipality was not audited.

### **APPRECIATION**

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

*Auditor-General*

**Mthatha**

**29 April 2008**



AUDITOR-GENERAL