

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

REPORT ON THE FINANCIAL STATEMENTS

Introduction

1. I have audited the accompanying group financial statements of the Amathole District Municipality which comprise the consolidated and separate statements of financial position as at 30 June 2007, consolidated and separate statements of financial performance, consolidated and separate statements of changes in net assets and consolidated and separate cash flow statements 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 58 to 98.

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 the Amathole District 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 the accounting policy note 1 of the annual financial statements.

Basis for adverse opinion**Infrastructure, plant and equipment**

10. GAMAP 17: *Property, Plant and Equipment* prescribes that where an asset is acquired at no cost, or for a nominal cost, its cost is its fair value as at the date of acquisition.

On 1 July 2006 the municipality assumed responsibility for the provision of water and sanitation services in its district in terms of Government Notice 849 issued in terms of section 84(3)(a) of the Municipal Structures Act, 1998 (Act No.117 of 1998).

In terms of this notice, the water and infrastructure assets of seven local municipalities within the district were transferred to the Amathole District Municipality. The municipality engaged the services of a consulting engineer to value these assets on the date of transfer. These valuations were used as a basis of recording these infrastructure assets in the asset register and the annual financial statements.

The engineer's working papers reflect that an estimated depreciated cost and not fair value, as prescribed by GAMAP 17, was calculated for each asset.

As a result, it is estimated that the gain on transfer of water infrastructure is understated by R129.5 million, the depreciation expense for the year is understated by R16.2 million and the carrying value of infrastructure assets is understated by R113.3 million.

11. Paragraph 35 of GAMAP 17: *Property Plant and Equipment* requires subsequent expenditure relating to an item of property, plant and equipment that has already been recognised to be added to the carrying amount of the asset when it is probable that future economic benefits or service potential over the total life of the asset in excess of the most recently assessed standard of performance of the existing asset, will flow to the entity. All other subsequent expenditure shall be recognised as an expense in the period in which it is incurred.

Audit tests conducted on a sample of repairs and maintenance expenditure transactions revealed that expenditure of R886 831 was expensed instead of

being capitalised to the cost of property, plant and equipment in accordance with this requirement.

The errors identified appear to be recurring in nature and are an indication that the repairs and maintenance expense and property, plant and equipment disclosed in the financial statements are materially misstated. The full extent of the errors could not be quantified.

Inventory

12. Paragraph 38 of *GAMAP 12: Inventories* requires the carrying amount of inventories held for distribution to be recognised as an expense in the period in which the related revenue is recognised. If there is no related revenue, the expense is recognised when the goods are distributed.

Housing development inventory of R49.7 million is disclosed in note 5 to the annual financial statements. The amount capitalised represents all expenditure incurred on the housing projects to date. According to the municipality's records, 1 924 completed housing units had been distributed to housing beneficiaries at 30 June 2007. The annual financial statements do not reflect any adjustments in respect of the distributed houses. Furthermore it was not possible to quantify the costs to be transferred to the statement of financial performance or to quantify the amount of the prior year adjustment as details of completed houses at the end of 2005 and 2006 together with detailed unit costing schedules (including infrastructure costs) could not be provided for audit purposes.

As a result, inventory and the accumulated surplus are overstated whilst expenditure is understated by a material amount that could not be quantified.

13. Adequate records such as inventory registers that record receipts, issues and available inventory on site were not maintained for materials that were purchased by the municipality and delivered directly to the project sites. Furthermore no evidence could be produced that physical counts were conducted and that such counts were reconciled to the materials on hand. As a result it was not possible to verify the existence of materials on site. It was also not possible to verify that all material purchased was used for the purpose acquired. The effect of this finding on inventory and expenditure disclosed in the financial statements could not be quantified.
14. The municipality does not have adequate systems in place to identify and quantify unsold purchased water inventory as prescribed by *GAMAP 12: Inventories*. Accordingly the annual financial statements do not disclose unsold water inventory. Water purchases of R24 million are included in the expenditure for the year under review. It was not possible to quantify the effects thereof as no records of water are maintained. Furthermore, own water is also included in reservoirs and storage tanks and the distinction between owned and purchased water could not be determined. As a result, inventory and expenditure is misstated by an amount that could not be quantified.

Payables – water and sanitation services

15. Government Notice 849 transfers all of the rights, obligations, assets and liabilities in respect of water and sanitation services of seven local municipalities to Amathole District Municipality. The annual financial statements recognise only the water and sanitation infrastructure and related long term loans of six out of the seven local municipalities. No provision was raised for claims in respect of unpaid water service costs that may have been outstanding at 1 July 2006 and that have not been submitted by these local municipalities.

As a consequence, payables and the gain on transfer of water infrastructure may be misstated by a material amount that cannot be quantified.

Water revenue

16. Section 64 of the MFMA requires the municipal manager to take reasonable steps to ensure that effective revenue collection systems are in place.

A lack of monitoring by management impacted on the municipality's water and sanitation revenue collection systems and its ability to collect revenue during the year under review.

This resulted in incorrect water tariffs being applied to consumer accounts, inadequate documentation being available to support sanitation charges, consumers not being billed every month, property transfers not being effected on the billing system, consumer deposits not existing for all consumer accounts, and no estimated revenue being raised for the period between the last meter reading and the financial year end. The misstatement of revenue and receivables as a result of the errors noted could not be quantified.

Employee costs

17. The municipality did not confirm the employment benefits of the water service employees who were absorbed into the personnel structure of the municipality as a result of the transfer of the water and sanitation services in writing. The only available documentation relating to their employment benefits was correspondence from their previous employer notifying them that they would be transferred to the Amathole District Municipality on their existing benefits.

The audit reports for the financial year ended 30 June 2006 of six out of the seven municipalities from where these officials were absorbed contained qualification paragraphs relating to employment benefits and leave records. No reliance could thus be placed on the employment records of these municipalities in order to verify the conditions of service of the absorbed employees. Furthermore, the salaries and benefits of the employees tested during the audit did not reconcile to the post grade/ levels recommended by the South African Local Government Association.

As a result, it was not possible to verify the occurrence and accuracy of the employee related costs of R9.3 million paid in respect of the services provided by these employees during the year under review.

Adverse opinion

18. In my opinion, because of the significance of the matters described in the basis for adverse opinion paragraphs, the financial statements do not present fairly, in all material respects, the financial position of the Amathole District Municipality and the group as at 30 June 2007 and its financial performance and cash flows for the year then ended, 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 MFMA.

Emphasis of matters

19. I draw attention to the following matters:

Highlighting a matter affecting the financial statements

Unauthorised expenditure

20. The budget of the engineering department was exceeded resulting in unauthorised expenditure of R10 million. This unauthorised expenditure is disclosed in note 28 to the annual financial statements.

Basis of accounting

21. 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*.

Unaudited supplementary schedules

22. The schedules set out on pages 156 to 170 do not form part of the annual financial statements and are presented for information purposes only. Accordingly, they have not been audited and no opinion is expressed thereon.

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

Annual report

23. At the date of this report the 2005-06 annual report had not been published as required by section 21A of the Municipal Systems Act, 2000 (Act No. 32 of 2000) and section 127(5) of the MFMA.

Upper limits of salaries – Municipal Entity

24. Although the salary, allowances and other benefits of the chief executive officer and senior managers of the Amathole Economic Development Agency (Proprietary) Limited were reviewed by the parent municipality's management and the annual increases awarded were in line with the increases of department heads of Amathole District Municipality, they have not been approved by council as prescribed by section 89(1) of the MFMA.

Transactions on the primary bank account

25. The mayor and speaker were issued municipal credit cards in a previous financial year in order to enable them to effectively utilise their budgets. During the year under review transactions with a value of R55 788 were recorded on these cards.

In terms of section 11(1) of the MFMA only the municipal manager, chief financial officer or another delegated official may authorise the withdrawal of municipal funds from the primary bank account.

The credit card expenditure referred to above is debited automatically against the primary bank account at the end of each month. This arrangement does not comply with the requirements of section 11(1) of the MFMA and the expenditure incurred on these credit cards is thus irregular.

Matters of governance

Internal audit

26. The approach and methodology adopted by the internal audit function is not formally documented. This resulted in significant documentation deficiencies in the internal audit files that were used to support the internal audit reports issued during the year.

Credit Card Expenditure

27. Transactions with a value of R117 292 were incurred during the year on the credit cards that were allocated to the municipal manager and chief financial officer.

Explanations and supporting documentation was requested from the municipal manager in respect of the expenditure of R94 270 incurred on the credit card that was allocated to him. These have not been provided.

Furthermore, expenditure of R23 022 was incurred on the credit card that was allocated to the chief financial officer. Explanations provided indicate that personal expenditure of R14 470 was incurred on this card.

In the absence of a policy or guideline that regulates the use of the credit cards it was not possible to determine whether the abovementioned expenditure was incurred for the purposes as was originally intended by the municipality.

These matters require further investigation.

Travelling and subsistence

28. An analysis of motor vehicle hire expenditure incurred during the year and the applicable provisions and prescripts of the subsistence and travel policy, in respect of the entitlement of the mayor, speaker and municipal manager to motor vehicle hire, revealed non-adherence to the policy. The full extent of the additional costs as a result of this non-adherence could not be determined.

Material corrections made to the financial statements submitted for audit

29. The financial statements, approved by the accounting officer and submitted for audit on 31 August 2007, have been significantly revised in respect of the following misstatements identified during the audit:

- Expenditure on housing development projects was credited directly to accumulated surplus. This resulted in an overstatement of the accumulated surplus and general expenditure of R11.5 million,
- A system error resulted in the value added tax on outstanding levy and water receivables being recorded in revenue and not a VAT suspense account that was included in payables. This resulted in an understatement of payables and an overstatement of revenue of R4.4 million,
- Consumer billing errors of R4.3 million were detected during the audit resulting in an overstatement of revenue and receivables,

- Infrastructure work in progress recognised as a result of the take over of the water services function was capitalised at the incorrect amount. This resulted in an understatement infrastructure, property, plant and equipment and deferred income of R75 million,
- The capital budget approved by council on 26 May 2007 was not included in commitments resulting in an understatement of the amount disclosed as approved but not yet contracted of R172.5 million;
- The provision for impairment of accounts receivable was increased by R33.1 million. As a result, expenditure was understated and receivables overstated by the same amount.

Internal control

30. 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	Assessment of risks	Control activities	Information and communication	Monitoring
Infrastructure assets, plant and equipment					X
Inventory					X
Water payables			X		
Revenue			X		
Employee costs					X
Unauthorised expenditure		X			
Non-compliance with applicable laws and regulations					X
Matters of governance					X
Material			X		

Reporting item	Control environment	Assessment of risks	Control activities	Information and communication	Monitoring
corrections to the financial statements					

Control activities

The effectiveness of control activities was not adequate. This is evident from the matters reported relating to revenue, payables and material changes to the financial statements.

Monitoring of controls

The monitoring controls such as the review of reconciliations, confirmations from external parties and internal processes were not effective. This contributed to the matters reported relating to infrastructure, plant and equipment, inventory and employee costs, credit cards and subsistence and travelling, non compliance with laws and regulations and matters of governance.

The internal audit department did not provide an effective service to management by assisting them with their governance responsibilities.

OTHER REPORTING RESPONSIBILITIES

Reporting on performance information

31. I have audited the performance information as set out on pages 117 to 149.

Responsibility of the accounting officer for the performance information

32. 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).

Responsibility of the Auditor-General

33. 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 Local Government: Municipal Systems Act, 2000 (Act No. 32 of 2000).

34. In terms of the foregoing my engagement included 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 judgement.

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

Audit findings (performance information)

36. No significant findings were identified as a result of my audit.

APPRECIATION

37. The assistance rendered by the staff of the Amathole District Municipality during the audit is sincerely appreciated.

Auditor-General

East London

21 December 2007



AUDITOR-GENERAL