

## ANNEXURE "D"

### **REPORT OF THE AUDITOR-GENERAL TO THE EASTERN CAPE PROVINCIAL LEGISLATURE AND THE COUNCIL ON THE FINANCIAL STATEMENTS OF MAKANA MUNICIPALITY FOR THE YEAR ENDED 30 JUNE 2008**

#### **REPORT ON THE FINANCIAL STATEMENTS**

##### **Introduction**

1. I have audited the accompanying financial statements of the Makana Municipality which comprise the balance sheet as at 30 June 2008, income statement and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes, 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 entity-specific basis of accounting, 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) and the Division of Revenue Act, 2007 (Act No. 1 of 2007) (DoRA). 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) (PAA), 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 and *General Notice 616 of 2008*, issued in *Government Gazette No. 31057 of 15 May 2008*. Those standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance on 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. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

### **Basis of accounting**

8. The municipality's policy is to prepare financial statements on the entity-specific basis of accounting, as set out in accounting policy note 1 to the financial statements.

### **Basis for adverse opinion**

#### **Operating revenue**

9. In terms of section 62(1)(b) of the MFMA, the accounting officer should ensure that full and proper records of the financial affairs of the entity are kept. The municipality did not perform a reconciliation of erven or property values between the property valuation roll and the system used to calculate the rates charges. I was therefore unable to obtain sufficient audit evidence as to the completeness of rates revenue to the amount of R23 million as disclosed in appendix D to the annual financial statements for the year. In addition, a predictive test was performed on assessment rates and an irreconcilable difference of R2,5 million was noted.
10. Revenue from electricity sales totalling R41,090 million was reported on appendix D of the financial statements. Included in this amount is a balance of R5,3 million which relates to the sale of prepaid electricity. The municipality does not reconcile the amounts receipted during the year for prepaid electricity sales to the reports generated by the various vendors. On comparison, we found that the revenue exceeded the total per the vendor reports by R1,8 million. Management was not able to provide an adequate explanation for the difference.
11. In addition, the municipality reported electricity reticulation losses of 23 per cent (2007: 10 per cent). I was therefore unable to verify the completeness and accuracy of the prepaid electricity revenue.

#### **Goods and services**

12. Supporting documentation relating to expenditure to the estimated value of R5,6 million could not be provided for audit purposes. This amounts to a scope limitation for which no alternative audit procedures were available. I am therefore unable to conclude as to the occurrence, accuracy and classification of expenditure amounting to R89,1 million as disclosed in appendix D to the annual financial statements.

## **Leases**

13. The municipality has categorised all identified lease contracts as operating leases and has therefore expensed all related payments. These leases, however, meet the definition of finance leases and were therefore incorrectly classified. The relevant asset should therefore have been capitalised and the corresponding liability raised in the balance sheet of the municipality. A complete register of lease commitments and contracts was not kept and as a result I was unable to determine the extent of the misstatement.

## **Irregular expenditure**

14. In terms of section 111 of the MFMA, the accounting officer must ensure that the municipality has and implements a supply chain management policy (SCM). However, goods and services totalling R1,6 million were found to have been procured from suppliers without having followed the required SCM procedures. In addition, tender documentation requested could not in all instances be presented for audit purposes.

15. In addition, it was noted that the tender register was incomplete as goods and services amounting to R4,8 million were procured from suppliers that could not be identified on the tender register.

16. The significance thereof represented a limitation of scope on the audit work that could be performed. Consequently I was unable to determine whether all the SCM Regulations as set out in the MFMA were complied with and confirm the completeness of irregular expenditure incurred for the year under review.

## **Unauthorised expenditure**

17. The municipality did not expense their Vuna Award received in line with the approved business plan, which details how the award was to be utilised. As a result, R400 000 of the award, allocated for the purchase of a tipper truck, was expensed to replace the mayoral vehicle. As the expenditure was not in line with the original business plan and the conditions of the award, it is considered unauthorised expenditure and should have been disclosed as such.

## **Creditors**

18. Creditors amounting to R23,090 million is reported in note 13 to the financial statements. Included in this amount is a balance of R972 605 (2007: R774 913) for trade creditors. Adequate documentation in support of the trade creditors could not be provided for audit purposes.

19. In addition, the municipality did not prepare supplier reconciliations and does not have an adequate alternative system of ensuring that all goods and services received prior to year-end but had not yet been paid for, are accrued. As a result, it was found that accruals amounting to R594 536 had not been included in the creditors reported. Furthermore, supporting documentation totalling R369 469 could not be provided for suspense accounts as reported in note 13 to the financial statements.

20. Consequently, it was not possible to determine the existence, valuation and completeness of creditors as disclosed in note 13 to the annual financial statements.

### **Value-Added Tax (VAT)**

21. The municipality has not prepared a reconciliation of the output VAT declared and the vatable revenue receipted during the year. A comparison performed indicated a possible over-declaration of R2,1 million to the South African Revenue Service.
22. The VAT liability as reported in note 13 to the financial statements, disclosed under suspense accounts, amounts to R838 258. This liability differed from the VAT 201 for the period ended June 2008 by an amount of R1,1 million. Management was not able to provide an adequate explanation for the difference.
23. In addition, it was found that the municipality was still using an apportionment percentage when claiming input VAT. However, effective from 1 July 2006, rates became zero-rated supplies, and all input VAT should therefore have been claimed from then onwards.
24. Consequently, it was not possible to confirm the completeness, existence and valuation of the VAT liability as reported above.

### **Employee costs**

25. In terms of section 62(1)(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 employee costs during the year under review. The payroll was not subject to proper review and authorisation. I was therefore unable to verify employee salaries against employment contracts or appointment letters and physically verify certain employees. Various deficiencies were detected with regard to leave records and attendance registers. Furthermore, supporting documentation required for debit journal entries to the value of R1,6 million and credit journal entries to the value of R1,2 million could not be provided for audit purposes.
26. The significance thereof represented a limitation of scope on the audit work that could be performed. Consequently, I am unable to determine the accuracy, occurrence and completeness of employee costs amounting to R60,630 million as disclosed in appendix D to the financial statements.

### **Fixed assets**

27. In terms of section 62(1)(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 the assets during the year under review. This is as a result of asset records not being continuously and effectively monitored by management. The asset register is deficient in that it is not completely and accurately populated and therefore not adequately maintained and supported by the appropriate documentation. Based on the above deficiencies, it was not possible to locate assets for physical verification nor trace assets to the asset register.
28. In addition, periodic reconciliations between the general ledger and the fixed asset register were not performed. A comparison between the asset register and the annual financial statements revealed unreconciled differences amounting to R6,6 million.

29. In the absence of adequate fixed asset records, it was not possible to verify the valuation, accuracy, existence, completeness and ownership of assets of the municipality to the value of R16,815 million as disclosed in note 6 to annual financial statements.

### **Bank and cash**

30. In terms of section 10 of the MFMA, the accounting officer is responsible for the administration of the municipality's bank accounts. However, it was found that the cash book balance was not reconciled timeously to the bank statements and was also not reconciled to the bank account in the general ledger. The overdraft balance of R733 590 disclosed on the balance sheet of the financial statements differs from the cash book by R1,2 million.

31. Furthermore, adequate supporting documentation for journal entries processed against the bank ledger account totalling R2,8 million could not be provided for audit purposes. No alternate audit procedures were available, therefore I was unable to conclude on the completeness, existence, valuation, rights and obligations and cut-off of bank and cash at year-end.

### **Debtors**

32. The municipality does not have a bad debt provision policy which enables it to identify all potential bad debts. The municipality's bad debt provision amounted to R66,228 million, as reported in note 10 to the financial statements. However, I was not able to assess the reasonableness of this provision as no suitable evidence was provided in support thereof. An analysis of debtor ageing and receipts after year-end revealed a possible R25 million understatement of the provision and consequently debtors are also overstated by this amount.

33. In addition, included in the debtors suspense account as disclosed in note 10 to the financial statements, is a medical aid suspense credit balance of R534 798 which relates to medical aid contributions received from retired employees and paid over to the medical aid fund on their behalf. The account balance should be cleared monthly when payments are made to the medical fund. The valuation of debtors in the financial statements is therefore understated by R534 798 and creditors are overstated by this amount.

### **Provisions**

34. The Municipality, which operates landfill sites, has an obligation in terms of S 28 of the National Environment Management Act, No 107 of 1998 to restore such sites. The municipality does not assess the remaining useful life of landfill sites. Detailed records of the capacity of landfill sites are not maintained by the municipality's engineers. Consequently, a provision for the rehabilitation of landfill sites has not been raised in the financial statements. Due to the specialist nature of such a provision and lack of appropriate records, I was unable to determine the extent of the misstatement.

35. The municipality pays vesting bonuses to its employees either during their birthday month or in November each year. The municipality had not provided for the vested portion staff bonuses at 30 June 2008.

36. Furthermore, the municipality did not use actual leave balances and pay rates per employee in calculating the provision for leave pay amounting to R2,491 million as

reported in note 12 to the financial statements. Due to the inadequate leave records and discrepancies in such records, I was unable to determine the extent of the misstatement in the financial statements.

37. The municipality has disclosed a provision of R161 250 for post-retirement medical benefits for retired staff. However, accurate records are not maintained to reflect new retirements, deaths and values of medical aid obligations. .
38. I was therefore unable to satisfy myself as to the accuracy and completeness of the provisions as reported in note 12 to the financial statements.

#### **Capital commitments**

39. Capital commitments of R16,7 million were calculated on an incorrect basis and no accurate records are kept in this regard. In the absence of proper records, we were unable to perform alternative procedures to determine the full extent of the misstatement in the financial statements. I was therefore unable to conclude on the accuracy, completeness and classification of the capital commitment disclosure.

#### **Adverse opinion**

40. In my opinion, because of the significance of the matters described in the Basis for adverse opinion paragraphs, the financial statements of Makana Municipality as at 30 June 2008 and its financial performance and cash flows for the year then ended have not been prepared in all material respects, in accordance with the basis of accounting as set out in note 1 to the financial statements and in the manner required by the MFMA and DoRA.

#### **Emphasis of matters**

I draw attention to the following matter:

#### **Highlighting critically important matters presented or disclosed in the financial statements**

##### **Statutory funds**

41. Approximately R22 million of the fund balances reported in appendix A had been borrowed to fund the operations of the municipality. It is considered unlikely that these amounts would be repaid timeously, which could affect the completion of capital projects as delays may be experienced due to a shortage of available funds.

#### **OTHER MATTERS**

I draw attention to the following matters that relate to our responsibilities in the audit of the financial statements:

##### **Internal controls**

42. 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 that gave rise to the inefficiencies in the system of internal control, which led to the adverse opinion. The root causes are categorised according to the five

components of an effective system of internal control. In some instances deficiencies exist in more than one internal control component.

Reporting item	Control environment	Risk assessment	Control activities	Information and communication	Monitoring
Operating revenue					X
Goods and services					X
Irregular expenditure					X
Creditors					X
VAT					X
Employee costs					X
Fixed assets					X
Bank and cash					X
Provisions					X
Capital commitments					X

Control environment: establishes the foundation for the internal control system by providing fundamental discipline and structure for financial reporting.

Risk assessment: involves the identification and analysis by management of relevant financial reporting risks to achieve predetermined financial reporting objectives.

Control activities: policies, procedures and practices that ensure that management's financial reporting objectives are achieved and financial reporting risk mitigation strategies are carried out.

Information and communication: supports all other control components by communicating control responsibilities for financial reporting to employees and by providing financial reporting information in a form and time frame that allow people to carry out their financial reporting duties.

Monitoring: covers external oversight of internal controls over financial reporting by management or other parties outside the process; or the application of independent methodologies, like customised procedures or standard checklists, by employees within a process.

### Non-compliance with applicable legislation

#### *Municipal Finance Management Act*

43. During the performance of our audit, it was noted that the municipality had not complied with section 62(1)(c)(i) of the MFMA as management did not perform a risk assessment during the year.
44. The municipality had not complied with section 65(2)(e) of the MFMA, as creditors were not paid within 30 days of receiving the relevant invoice or statement.

### Matters of governance

45. The MFMA tasks the accounting officer with a number of responsibilities concerning financial and risk management and internal control. Fundamental to achieving this is the implementation of certain key governance responsibilities, which I have assessed as follows:

<b>Matter of governance</b>	<b>Yes</b>	<b>No</b>
<b>Audit committee</b>		
The municipality had an audit committee in operation throughout the financial year.		<b>X</b>
The audit committee operates in accordance with approved, written terms of reference.	<b>X</b>	
The audit committee substantially fulfilled its responsibilities for the year, as set out in section 166(2) of the MFMA.		<b>X</b>
<b>Internal audit</b>		
The municipality had an internal audit function in operation throughout the financial year.		<b>X</b>
The internal audit function operates in terms of an approved internal audit plan.	<b>X</b>	
The internal audit function substantially fulfilled its responsibilities for the year, as set out in section 165(2) of the MFMA.		<b>X</b>
<b>Other matters of governance</b>		
The annual financial statements were submitted for audit as per the legislated deadlines contained in Section 126 of the MFMA for municipalities.	<b>X</b>	
The annual report was submitted to the auditor for consideration prior to the date of the auditor's report.		<b>X</b>
The financial statements submitted for audit were not subject to any material amendments resulting from the audit.		<b>X</b>
No significant difficulties were experienced during the audit concerning delays or the unavailability of expected information and/or the unavailability of senior management.		<b>X</b>
The prior year's external audit recommendations have been substantially implemented.		<b>X</b>
<b>Implementation of Standards of Generally Recognised Accounting Practice (GRAP)</b>		
The municipality submitted an implementation plan, detailing progress towards full compliance with GRAP, to the National Treasury and the relevant provincial treasury before 30 October 2007.	<b>X</b>	
The municipality substantially complied with the implementation plan it submitted to the National Treasury and the relevant provincial treasury before 30 October 2007, detailing its progress towards full compliance with GRAP.	<b>X</b>	
The municipality submitted an implementation plan, detailing further progress towards full compliance with GRAP, to the National Treasury and the relevant provincial treasury before 31 March 2008.		<b>X</b>

## **OTHER REPORTING RESPONSIBILITIES**

### **REPORT ON PERFORMANCE INFORMATION**

46. I have reviewed the performance information as set out on pages xx to xx.

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

47. 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**

48. We conducted our engagement in accordance with section 13 of the PAA read with *General Notice 616 of 2008*, issued in *Government Gazette No. 31057 of 15 May 2008* and section 45 of the MSA.
49. In terms of the foregoing, our 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.
50. We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for the audit findings reported below.

## **Audit findings (performance information)**

### **Non-compliance with regulatory requirements**

#### **No reporting of performance information**

51. The municipality did not prepare an annual performance report as required in terms of section 46 of the MSA and section 121(3)(c) of the MFMA.

#### **Content of integrated development plan**

52. The integrated development plan of municipality did not include the key performance indicators and performance targets determined in terms of its performance management system, as required by section 26(i) of the MSA.

#### **No quarterly reporting on performance information**

53. No quarterly reports on the progress in achieving measurable objectives and targets were prepared by the different programme managers and as a whole for the municipality to facilitate effective performance monitoring, evaluation and corrective action, as required by the Treasury Regulations.

#### **Lack of sufficient appropriate audit evidence**

54. We were unable to obtain sufficient appropriate audit evidence in relation to the performance information of the municipality, as the system used for generating information was not adequate for purposes of such evaluation. Under these circumstances it was not possible to confirm that this information is complete and accurate.

#### **Changes to planned performance information not approved**

55. Changes to the outputs / measures / indicators / targets in the current year's strategic plan were not approved.

## APPRECIATION

56. The assistance rendered by the staff of the Makana Municipality during the audit is sincerely appreciated.

*Auditor-General*

East London

26 November 2008



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