REPORT OF THE AUDITOR-GENERAL TO THE EASTERN CAPE PROVINCIAL LEGISLATURE AND COUNCIL OF THE KOUGA MUNICIPALITY ON THE FINANCIAL STATEMENTS AND PERFORMANCE INFORMATION OF THE KOUGA MUNICIPALITY FOR THE YEAR ENDED 30 JUNE 2008

REPORT ON THE FINANCIAL STATEMENTS

Introduction

1. I have audited the accompanying financial statements of the Kouga municipality which comprise the statement of financial position as at 30 June 2008, 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 report, as set out on pages 19 to 78.

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 as determined by the National Treasury as set out in note 1 of the accounting policy and in the manner required by the Local Government: Municipal Finance Management Act, 2003 (Act No. 56 of 2003) (MFMA) and Auditor-General audit circular 1 of 2008 and 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. 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 not effective for this financial year, I have determined that my audit of any disclosures made by the Kouga 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 (PPE)

10. Property, plant and equipment amounted to R 204.9 million in the statement of financial position at year end and as disclosed in note 12 to the financial statements. As a result of the circumstances detailed below, the extent to which property, plant and equipment might be misstated could not be determined:

    10.1. Infrastructure assets had not been recorded under PPE in the statement of financial position of the municipality before the implementation of GRAP/GAMAP as required by GAMAP 17 Property, plant and equipment. The record keeping of the municipality was inadequate to perform alternative procedures to determine the completeness of PPE. The exclusion of infrastructure from PPE will also have an impact on deficit for the year as the completeness of depreciation in the statement of financial performance will be understated due to the depreciable amount of infrastructure asset not being depreciated over their estimated useful life.

    10.2. Land that had been acquired at nil value was included in PPE at a nil value instead of being recorded at fair value at the date of acquisition, as required by GAMAP 17.25. Appropriate procedures, techniques and mechanisms did not exist with respect to the valuation of property acquired at a nil or nominal value at its fair value.

    10.3. Acquisitions of PPE amounted to R54 million as disclosed in note 12 to the annual financial statements. Assets that amounted to R1.1 million were incorrectly expensed as operating expenditure in the statement of financial performance, contrary to the requirements of GAMAP 17 Property, plant and equipment. I was unable to obtain sufficient, appropriate audit evidence to determine the full extent to which PPE and expenditure were misstated in the financial statements due to inadequate controls and records in place. As a result of the misstatement, PPE, expenditure and accumulated surplus were understated and deficit for the year was overstated in the financial statements.

Government grants and subsidies

11. Government grants and subsidies recognised as income in the statement of financial performance for the year ended 30 June 2008 amount to R 32.8 million. Conditional grants related to housing are recognised as revenue when the houses are constructed and the amounts expended. Included in the above-mentioned balance are conditional grants related to housing projects to the amount of R16.9 million. (See note 24.3 to the financial statements.) Housing records to verify the administration and allocation of low-cost houses could not be provided in time for audit purposes. I was unable to verify that projects had been completed and that all expenditure incurred for housing had occurred. No alternative procedures could be performed as the municipality's record keeping was inadequate to perform other alternative procedures to verify the occurrence of the transactions in the statement of financial position. This audit finding was also reported in the 2006-07 audit report.

Revenue and receivables/Debtors

12. Revenue from property rates was reflected at R66 million in the statement of financial performance. Revenue from property rates was not complete as not all properties had been rated for property rates in terms of the applicable legislation. Property rates to an estimated amount of R4 million had not been recorded in the statement of financial performance. The misstatement occurred as there were inadequate controls in place over the completeness of the municipal property register. As result of the misstatement, accumulated surplus, property rates and customer debtors were understated by an estimated R4 million, whereas the deficit for the year was overstated by this amount.

13. Revenue from fines for the year was reflected as R3.1 million in the statement of financial performance. Revenue from fines was not complete as it was incorrectly recognised on the cash basis in accounting policy note 13.2.2 instead of on the accrual basis of accounting in terms of GAMAP 9, paragraph 39. Revenue to the amount of at least R1.1 million had not been recorded in the statement of financial performance. The misstatement occurred as there were inadequate controls in place over the completeness of the fines register. As result of the misstatement, accumulated surplus, fines and other debtors were understated by R1.1 million, whereas the deficit for the year was overstated by R 1.1 million.

14. Municipal land sold during the 2007-08 financial year was recorded in the statement of financial performance as gains on disposal of PPE amounting to R8.1 million. The necessary supporting documentation was not provided during the audit in order to verify the completeness, cut-off and accuracy of the land sale transactions reflected in the financial statements. No alternative procedures could be carried out as the record keeping of the municipality was inadequate to determine the amount that should be included in revenue from gains on disposal of PPE. This audit finding was reported in the 2006-07 audit report.

Expenditure and creditors

15. The municipality reflected creditors at year-end in the statement of financial position to the amount of R29.2 million. The necessary records were not provided during the audit in time to verify the completeness of creditors reflected in the financial statements. The alternative procedures that were carried out were inadequate to provide sufficient and appropriate audit evidence to confirm the completeness of creditors amounting to R10 million.

Provisions

16. The provision for post-retirement benefits was reflected in the statement of financial position as a non-current liability to the amount of R33.4 million. The actuarial report to support the amount provided was not provided during the audit. Furthermore, evidence that management had submitted the actuarial report to council for consideration could also not be provided. No alternative procedures could be carried as the record keeping of the municipality was inadequate to determine the accuracy of the valuation of the provision for post-retirement benefits.

Disclosure

17. Related-party transactions and relationships

17.1. Related-party transactions were disclosed in note 47 to the financial statement. The municipality did not disclose all related-party transactions involving management, as required by IAS 24.18. Management had not fulfilled their reporting responsibilities with regard to the disclosure of related-party transactions as a tender to an amount of R22 million was awarded to an affiliate of management without being disclosed as a related-party transaction in the notes to the financial statements.

17.2. The municipality did not disclose all related-party relationships involving management, councillors and municipal entities, as required by IAS 24.18. Management had not fulfilled their reporting responsibilities to ensure the completeness of disclosure for related-party relationships. As a result of the non-disclosure of related-party relationships in the financial statements, disclosure notes are not complete.

18. Irregular expenditure.

18.1. The municipality omitted to disclose irregular expenditure in note 37.3 to the financial statements amounting to R358 665. As also reported in the prior year audit report (2006-07 audit report paragraph 34), performance bonuses related to performance during the 2006-07 financial year were paid to MSA section 57 employees to an amount of R358 665 (see note 26 to the financial statements) without an oversight committee being in place and before the annual report was finalised, as required by Regulations 8, 23 and 34 of GNR 805 of August 2006, read with section 129(1) of the MFMA. The payment of these performance bonuses was contrary to the above-mentioned legislation and is therefore regarded as irregular. The non-disclosure occurred due to inadequate controls over financial reporting to ensure the completeness of disclosure of irregular expenditure. The completeness of irregular expenditure was understated in the financial statements.

18.2. Long-term receivables were disclosed in note 14 to the financial statements. Loans of R282 000 had been made to employees of the municipality in contravention of section 164(1)(c) of the MFMA. The loans made to employees were not disclosed in note 37.1 as irregular expenditure. The non-disclosure occurred due to inadequate controls over financial reporting to ensure the completeness of irregular expenditure. The completeness of the irregular expenditure disclosure was understated in the financial statements.

Opinion

Qualified opinion

19. In my opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had I been able to satisfy myself as to the matters described in the Basis for qualified opinion paragraphs, the financial statements present fairly, in all material respects, the financial position of the Kouga Municipality as at 30 June 2008 and its financial performance and cash flows for the year then ended, in accordance with basis of accounting and in the manner required by the MFMA and DoRA.

Emphasis of Matter

Highlighting critically important matters presented or disclosed in the financial statements

Unauthorised, irregular or fruitless and wasteful expenditure as well as material losses through criminal conduct

20.1. Unauthorised expenditure was disclosed in note 37.1 to the financial statements. The municipality had exceeded its originally adopted operating budget by 20%. (7%: 2006/7). The unauthorised expenditure amounting to R41.2 million (R14.4 million: 2006/7) was disclosed in note 37.1 to the financial statements. The escalating trend in overspending of the operating budget indicates that the municipality did not have adequate budgetary systems in place to prevent unauthorised expenditure from taking place.

20.2. Fruitless and wasteful expenditure was disclosed in note 37.2 to the financial statements.The municipality had incurred interest of R156,925 for late payments to creditors. The fruitless and wasteful expenditure amounting to R156,925 was disclosed in note 37.2 to the financial statements. The municipality did not have adequate controls in place to effectively manage the working capital of the municipality.

Restatement of corresponding figures

20.3. As disclosed in note 33 to the financial statements, the corresponding figures for 30 June 2007 have been restated as result of an error discovered during 30 June 2008 in the financial statements of the Kouga Municipality at, and for the year ended, 30 June 2007.

OTHER MATTERS

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

Value- for-money matters

21 Capital budget not utilised:

21.1 Capital expenditure was disclosed in annexure E(2) to the financial statements. The council had budgeted for capital expenditure of R109 million for the 2007-08 financial year, but only R97.8 million (90%) of which R46.9 million was capital under construction at year-end, was spent (also see note 12 to the financial statements). Although there was an improvement on the prior year spending rate, the continued underspending or delayed spending of the capital budget had a negative effect on service delivery. In addition, the budget for borrowing cost and depreciation impacts on the rates tariff set in preparation of the annual operating budgets. The non-delivery of budgeted capital projects therefore implied that the ratepayer had not received value for money for rates paid. (Prior year audit report paragraph 20 also refers.)

21.2. An amount of R103 million was disclosed in note 12 to the financial statement for PPE additions and capital under construction in the financial year. An amount of R47.8 million for additions and capital under construction for PPE could not be assessed for value for money as the municipality was unable to provide the pertinent tender documentation underpinning the expenditure incurred.

Internal controls

22. 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 disclaimer of 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
Basis for qualified opinion					
Property, plant and equipment	✓		✓		
Government grants and subsidies	✓				
Revenue and receivables			✓	✓	
Creditors and expenditure	✓				
Provisions	✓				
Disclosure	✓		✓		

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.