

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

**REPORT ON THE FINANCIAL STATEMENTS**

**Introduction**

1. I was engaged to audit the accompanying financial statements of the Engcoco Local 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 ....to....

**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 to the financial statements 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 5 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 conducting the 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*. 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 Municipal Finance Officers in its code of Accounting Practice (1997) and on Report on Published Annual Financial Statements (Second edition – January 1996) as set out in accounting policy note 1 to the financial statements.

**Basis for disclaimer of opinion**

## **Property, plant and equipment**

5. 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 has not been exercised over the fixed assets register during the year under review and as a result the fixed asset register is not completely and adequately maintained. It has also been noted that reconciliation between assets register and general ledger is not done. Consequently, during the verification process of assets in the fixed assets register, fixed assets additions of R8,5 million could not be identified in the fixed assets register. Accordingly completeness and valuation of fixed assets amounting to (R13 547) disclosed in the financial statement could not be confirmed.
6. Supporting documentation in respect of journal entries amounting to R15,1 million processed through the fixed assets account balance were not submitted for audit purposes and I could not determine the impact of these transactions in the financial statements.

## **Funds and Reserves**

7. The revolving fund is disclosed in the financial statements with an amount of R729 411. However the dedicated investment account is reflected in the bank statement with an amount of R73 877 resulting to a difference of R655 534. Accordingly the revolving fund has been overstated by the same amount as it is not adequately backed by concomitant assets.
8. Supporting documentation in respect of journal entries amounting to R25,2 million processed through funds and reserves and accumulated surplus/(deficit) account were not submitted for audit purposes. I was unable to determine the impact of these journals in the accounting records as my scope was limited
9. Supporting documentation authorising the transfer amounting to R2,2 million made by the municipality from the funds and reserves to its operating bank account was not submitted for audit purposes. I was therefore unable to determine the impact of the transfer in the accounting records as my scope was limited.
10. Engcobo Local Municipality made a prior year adjustment indicating that monies received in respect of conditional grants should be taken straight to revenue instead of creating a fund. Furthermore it was noted that allocation amounting to R14 million made in terms of Division of Revenue Act in respect of these grants was not disclosed. Accordingly revenue has been understated in the financial statements by R14 million.
11. With reference to accounting policy number 4, paragraph 2: *statutory funds, trust funds and project funds*, from time to time, National and Provincial Governments provide funds to municipalities for the undertaking of certain prescribed projects. The funds so provided are not treated as operating grants upon receipts but revenue is recognized only upon spending of the funds for the designated purposes, to the extent of the expenditure. However expenses amounting to R42,7 million and incurred in respect of funds were not recognized as revenue during the period under review and supporting documentation detailing the purpose and use of grants received was not submitted for audit purposes. Accordingly revenue has been understated in the financial statements by the same amount.

### **Cash and Cash Equivalents**

12. Bank confirmation received from the bank, confirmed an amount of R2.2 million whereas the bank statement used in the preparation of bank reconciliations and cash book of the municipality reflect an amount of R863 823 in respect of cash and bank resulting to a difference of R1,3 million. Accordingly cash and bank has been understated in the financial statements.
13. Monitoring controls such as reviews and reconciliations were not effective at Engcobo Local Municipality and as a result amounts totalling to R747 715 in respect of reconciling items are not cleared. Accordingly, valuation and completeness of cash and bank balance of R863 823 as disclosed in the annual financial statements could not be confirmed.

### **Accounts Payable**

14. Included in the creditors of R9,4 million is the amount of R8 million in respect of internal advances (not disclosed in appendix B) borrowed from conditional grants without council approval and the institution from which such grant was received. Consequently, funds and reserves are understated by R8 million.
15. Supporting documentation in respect of journal entries amounting to R7,8 million, processed through the creditors account were not submitted for audit purpose. I was therefore unable to determine the impact of these journals in the accounting records as my scope was limited.
16. The creditors' suspense accounts disclosed as other deposits of R1,3 million per note 10 to the annual financial statements, are in respect of deposits from consumers that are outstanding and not cleared at year end. Furthermore, supporting documentation that I deemed necessary to verify the existence, valuation and rights and obligations of the balance was not submitted for audit purposes. The municipality's records did not permit the application of alternative audit procedures regarding the suspense accounts.

### **Value Added Tax**

17. Monitoring controls such as reviews and reconciliations were not effective at Engcobo Local Municipality and as a result reconciliation between VAT 201 returns for the amount of R2, 4 million in respect of value added tax submitted to South African Revenue Services and the general ledger were not performed during the period under review. Accordingly completeness and valuation of VAT disclosed in the financial statements could not be confirmed.
18. Value Added Tax (VAT) amounting to R2,4 million as per note 3 to the financial statements differs with VAT amount of R1, 2 million as confirmed by the receiver of revenue (SARS). Accordingly accounts receivable has been overstated in the financial statements by the same amount.

### **Accounts Receivable**

19. The debtors ageing analysis in respect of rates and service receivable submitted for audit purposes reflects a balance of R2, 4 million whereas as per note 3.1 to the financial statements an amount of R2, 6 million is disclosed. Accordingly, debtors have been understated by R215 539. Consequently valuation and rights and obligation could not be confirmed.
20. Supporting documentation in respect of journals processed in the account receivable amounting to R956 961 was not provided for audit purposes and as a result I could not confirm valuation of transactions.

21. With reference to paragraphs 3.6 of the credit control by-law for Engcobo Local Municipality, interest will be charged on all overdue accounts at an interest rate that shall be determined by the council from time to time. The municipality did not charge interest on long outstanding debtors for the current year and previous years. As the relevant information was not available I was not able to determine what the impact of this would be on accounts receivable, however considering the outstanding debtors at year end this amount is estimated to be material.

### **Investments**

22. The Investment register is not completely and accurately populated and is therefore not adequately maintained and supported by appropriate documentation. Consequently, the difference totalling R908 996 between investment register and general ledger was noted. Investments are thus understated by the same amount.
23. Monitoring control such as reviews and reconciliations were not effective at Engcobo Local Municipality during the period under review and as a result the investment amounts recorded in the general ledger and disclosed in note 5 to the financial statements did not reconcile to the investment amount in the general ledger. Consequently a difference totalling R8,3 million was noted. Accordingly valuation and completeness of investment could not be confirmed
24. Monitoring controls such as reviews and reconciliations were not effective at Engcobo Local Municipality during the period under review and as a result an amount of R2 million in respect of investments as per the investment register was recorded as a negative balance of R916 680 in the general ledger. Consequently the financial statements were understated by the investment amounting of R2,9 million.
25. Interest earned totalling R644 237 in respect of investments as disclosed in the financial statements, could not be confirmed per bank confirmations received from the bank where investments are held by the municipality and as a result, accuracy of interest earned could not be confirmed.

### **Revenue**

26. Supporting documentation for debit journal entries amounting to R62 700 and credit journals amounting to R12,3 million processed in the grants and subsidies account was not submitted for audit purposes and I was therefore, unable to determine the impact of transactions in the accounting records as my scope was limited.

### **Employee Costs**

27. Employment contracts in respect of employee costs of R933 907, incurred by the municipality were not submitted for audit purposes. I could therefore, not satisfy myself of the occurrence and accuracy of salaries, wages and allowance expenditure as my scope was limited.
28. Supporting documentation for the expenditure of R308 73 in respect of the mayoral fund was not submitted for audit purposes. Accordingly occurrence and accuracy of general expenditure disclosed in the financial statements could not be confirmed.
29. Monitoring controls such as reviews and reconciliations, were not effective at Engcobo Local Municipality during the period under review and as a result, a

difference between the trial balance and purchase vouchers amounting to R812 044 in respect of fuel, audit fees and hiring of equipment was noted and no management explanation was provided for audit purposes. Accordingly general expenditure might be overstated in the financial statements.

30. Supporting documentation in respect of journals processed in the general expenditure and repairs and maintenance accounts amounting to R2 million was not submitted for audit purposes, and as a result I could not determine the impact of the transactions as my scope was limited.

### **Capital commitments**

31. The municipality did not maintain a contracts register which provides particulars of all approved capital contracts, the expenditure incurred to date and the municipality's future capital commitments in respect of each contract. There were no alternative audit procedures that I could perform to obtain reasonable assurance that capital commitments to the sum of R11,5 million as disclosed under note 23 to the financial statements, are complete and recorded in the financial statements at appropriate amounts.

### **Irregular Expenditure**

32. In terms of the Engcobo Local Municipality's supply chain management policy and chapter 11 of the MFMA, a municipality shall award contracts for goods and services in accordance with a system that is fair, equitable, transparent, competitive and cost-effective. The following irregular expenditure was identified because the above was not complied with. Furthermore, this expenditure was not disclosed in the financial statements as irregular expenditure as required by section 125(2)(d) of the MFMA.

Bids for the supply of goods and /or services were not invited as required by supply chain management regulation 17. A payment of R15,7 million was made. Furthermore the municipality did not enter into service level agreements/contracts with service providers who were awarded tenders to provide goods and or services.

### **Unauthorised Expenditure**

33. The municipality has incurred an unauthorised expenditure of R985 115 as its budget has been exceeded by the same amount. However the municipality has not disclosed this amount in the notes to financial statements as required by section 125(2)(d)(i) of the MFMA.
34. The municipality has incurred expenditure amounting to R8 million for purposes other than those stipulated per conditions of a relevant grant and as a result unauthorised expenditure has been incurred. However the municipality has not complied with section 125(2)(d)(i) of the aforementioned Act by not disclosing a note to the financial statements to this effect.

### **Related Parties**

35. I was unable to obtain the representations considered necessary from the accounting officer with respect to the identification and balances of, and transactions with related parties. I could not determine the effect on the disclosures contained in the financial statements.

### **Contingent Liabilities**

36. The municipality does not maintain an updated register of litigations against it, and legal council responsibilities are outsourced to a legal representative (attorneys, lawyers and advocates) of whose list was not provided to me and thus I could not adequately obtain confirmations regarding litigations against the municipality. There were no alternative audit procedures that I could perform to obtain reasonable assurance that contingent liabilities do not exist on the part of the municipality.

**Disclaimer of opinion**

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

**Emphasis of matters**

I draw attention to the following matters:

**Amendments to the applicable basis of accounting**

38. The National Treasury approved a deviation from the basis of accounting applicable to the municipality in terms of General Notice 522 of 2007, issued in Government Gazette No. 30013 of 29 June 2007.

**OTHER MATTERS**

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

**Internal control**

39. 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	Assessment of risks	Control activities	Information and communication	Monitoring
<b>Basis for disclaimer of opinion</b>					
Property, plant and equipment			✓		
Funds and Reserves			✓		
Cash and Cash equivalents			✓		
Account payable					
Accounts receivable			✓		
Valued Added Tax			✓		

Reporting item	Control environment	Assessment of risks	Control activities	Information and communication	Monitoring
Investments			✓		
Revenue			✓		
Expenditure			✓		
Employee Costs			✓		
Capital commitments	✓				
Contingent Liabilities	✓				
Irregular Expenditure	✓				
Related Parties	✓				

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 allows 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.

### Material Non-compliance with applicable legislation

#### 40. Municipal Finance Management Act, 2003 (MFMA)

- Section 72(1) (a) states that the accounting officer of a municipality must by 25 January of each year, assess the performance of the municipality during the first half of the financial year. Engcobo Local municipality did not provide me with evidence that an assessment as required by this section was performed.
- Section 17(3)(b) of the MFMA was not complied with as measurable performance objectives for revenue from each source and for each vote in the budget, taking into account the municipality's integrated development plan, was not compiled and presented with the annual budget.

#### 41. Municipal Systems Act, 2000 (Act No. 32 of 2000) (MSA)

- Section 57(1) and (2) was not complied with as I was not provided with performance agreements of the section 57 managers for 2007/08 as they were not in place.

#### 42. Housing Act, 1997(Act 107 of 1997)

- Section 10(4f) of the Housing Act No 107 of 1997 states that the Chief Financial Officer of the municipality must as soon as possible after, but within

two months of 31 March in each year submit a signed detailed statement, showing the results of previous year's transactions and the balance sheet in respect of such account (housing fund) to the accounting officer. However Engcobo Local Municipality has not prepared any detailed statement of People's housing project funded by the provincial housing fund.

43. The Division of Revenue Act, 2007 (Act 5 of 2007) (DORA)

- Section 27 (5)(b) and (6) of DORA 2007, states that the municipality must issue quarterly reports to the National Treasury in the prescribed format for all grants received and expenditure incurred on the grants. The municipality did not issue the aforementioned quarterly reports.

**Matters of governance**

44. 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.		✓
• The audit committee operates in accordance with approved, written terms of reference.		✓
• The audit committee substantially fulfilled its responsibilities for the year, as set out in section 166(2) of the MFMA.		✓
<b>Internal audit</b>		
• The municipality had an internal audit function in operation throughout the financial year.	✓	
• The internal audit function operates in terms of an approved internal audit plan.		✓
• The internal audit function substantially fulfilled its responsibilities for the year, as set out in section 165(2) of the MFMA.		✓
<b>Other matters of governance</b>		
• The annual financial statements were submitted for audit as per the legislated deadlines section 126 of the MFMA for municipalities and municipal entities.		✓
• The financial statements submitted for audit were not subject to any material amendments resulting from the audit.		✓
• No significant difficulties were experienced during the audit concerning delays or the unavailability of expected information and/or the unavailability of senior management.		✓
• The prior year's external audit recommendations have been substantially implemented.		✓
• There are documented policies and procedures and control system to ensure the reliability of financial reporting.		✓
• There are documented policies and procedures and control system to ensure the compliance with applicable laws and regulations.		✓
• The information systems were appropriate to facilitate the preparation of financial statements that are free from material misstatement.		✓
• Delegations of responsibility are in place		✓



<b>Matter of governance</b>	<b>Yes</b>	<b>No</b>
• Supply chain management policies and procedures were appropriately applied.		✓
• There is a functioning performance management system		✓
• Based on the available information, performance bonuses are only paid proper assessment and approval by those charged with governance		✓

## **OTHER REPORTING RESPONSIBILITIES**

### **Reporting on performance information**

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

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

46. 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 MSA.

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

47. I conducted my 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.

48. 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.

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

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

#### **Internal auditing of performance measurements**

50. The internal auditors of the municipality did not audit the performance measurements on a continuous basis and did not submit quarterly reports on their audits to the municipal manager and the performance audit committee.

#### **Performance management plan not yet approved by council**

51. Section 40 of the MSA requires a municipality to establish mechanisms to monitor and review its performance management system. Council has not yet approved Engcobo Local Municipality Performance Management Plan.

#### **Measurable objectives not consistent**

#### **Measurable objectives are materially inconsistent between annual report and integrated development plan**

52. I draw attention to the fact that the measurable objectives reported in the annual report of the municipality are materially inconsistent when compared with the predetermined objectives as per the integrated development plan.

53. Section 46 of the MSA states that a municipality must prepare for each financial year a performance report reflecting the performance of the municipality and of each external service provider during that financial year, a comparison of the performances referred to in paragraph (a) with targets set for and performances in the previous financial year and measures taken to improve the performance. The municipality has not complied with these requirements and as a result I could not determine if the municipality reported against predetermined objectives.

#### **APPRECIATION**

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

*Auditor - General*

**Mthatha**

**13 February 2009**



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