

# REPORT OF THE AUDITOR-GENERAL TO THE KWAZULU-NATAL PROVINCIAL LEGISLATURE AND THE COUNCIL ON THE FINANCIAL STATEMENTS AND PERFORMANCE INFORMATION OF THE UMKHANYAKUDE DISTRICT 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 Umkhanyakude District 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, as set out on pages 1 to 18.

### 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 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 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) and section 126(3) of the MFMA, 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, as set out in accounting policy note 1 to the financial statements.

### Basis for disclaimer of opinion

I was unable to obtain sufficient appropriate audit evidence in respect of the following matters:

### Accumulated surplus and government grant reserve

5. In the statement of changes in net assets, the opening accumulated surplus balance was adjusted by a credit amount of R3 917 600. Management was unable to provide a breakdown or adequate documentation to support this adjustment. The records did not allow me to perform alternate procedures.

6. In the statement of changes in net assets, the opening accumulated surplus balance was adjusted by a credit amount of R758 773. This amount related to a prior period adjustment to depreciation, however, the adjustment was not applied retrospectively to all relevant balances.
7. In the statement of changes in net assets, the amount transferred to the government grant reserve of R95 745 082 and transfer of depreciation of R17 227 291, did not agree to the respective amounts reflected in the fixed assets register indicating fixed asset additions funded by government grants of R52 555 075 and associated depreciation of R16 844 761. Management was unable to provide me with explanations for the respective differences of R43 190 007 and R382 530. The records did not allow me to perform alternate procedures.
8. Included in the opening accumulated surplus were numerous adjustments (listed below) which were determined based on the prior year fixed asset closing balances. However, given the significant errors and uncertainties regarding the accuracy and completeness of fixed assets, I was unable to determine the accuracy and completeness of those adjustments. In the year under review, this situation remains unresolved and accordingly I remained unable to determine the accuracy and completeness of the following adjustments to government grant reserves and accumulated surplus which mainly relates from the conversion to General Accepted Municipal Accounting Practice (GAMAP) and the purchase of property plant and equipment (PPE):

• 2005 – Implementation of GAMAP	R25 595 661
• 2006 – PPE purchased	R412 375
• 2006 – Capital grants used to purchase PPE	R187 323 677
• 2006 - Offsetting of depreciation	R11 202 580
• 2006 – GAMAP	R13 418 850
• 2007 – Capital grants used to purchase PPE	R220 141 295
• 2007 – Offsetting of depreciation	R14 734 272
• 2007 – GAMAP adjustments	R56 992 550
• 2007 – Other adjustments	R5 763 965
• 2007 – Prior year adjustments	R7 737 946
• 2007 – PPE purchased	R310 831

9. Accordingly, I was unable to determine the existence, valuation, accuracy, completeness and classification of the closing balance of the government grant reserve of R487 569 065 and accumulated surplus of R90 380 099.

### **Fixed assets**

10. The prior year audit report identified the following matters, which continue to remain unresolved during the year under review:
  - An unrecorded prior year additions of R124 800 000 which were recorded as fixed asset additions during the financial year under review. The full extent of this error has not been quantified by management. In addition, accumulated depreciation attributable to these previously unrecorded additions was not determined instead only current year depreciation was determined.
  - I was unable to verify the accuracy and existence of any of the recorded additions of R124 800 000, as the supporting documentation was not available for inspection.
  - Assets with a recorded net book value of R618 000 had been disposed of in prior years but were not removed from fixed asset register. Furthermore, certain assets were not physically verified as management was unable to locate the assets.

- Unexplained discrepancies of capital work in progress amounting to R11 100 000 were identified between the recorded project amount in the fixed asset register of R104 600 000 and the recorded project amount in the general ledger of R93 600 000.
- A credit of R39 500 000 was reflected in fixed asset additions movement. Management could not provide evidence to support the existence and accuracy of this adjustment.
- Airstrip and land with a recorded cost of R7 500 000 are being depreciated. Management have not split this asset between land and buildings and hence the land element should not be depreciated

11. In the year under review the following matters were identified:

- The ownership of Manguzi Multi Sports Complex, with a cost of R15 038 057 had been handed over to a local municipality as at 26 June 2008 but was still recorded in the records of the municipality. The result was an overstatement of fixed assets by this amount.
- Fixed asset and capital work in progress additions were processed inclusive of Value Added Tax (VAT) resulting in an overstatement of fixed assets and an understatement of input VAT by R1 812 277.

12. The municipality's records did not permit the application of alternative audit procedures regarding fixed assets. Consequently, I did not obtain sufficient audit evidence to satisfy myself as to existence, accuracy, completeness and valuation of and rights relating to fixed assets.

### **Revenue and value added tax (VAT) - water and electricity sales**

13. A computer system design error resulted in the sales transactions initially being recorded inclusive of VAT. Only upon receipt from the debtor, is the VAT output element reversed to the VAT control account. Consequently revenue is overstated to the extent of the output VAT element in the outstanding consumer debtors' balance and the VAT control account will be understated by the same amount. This system flaw has existed since the inception of the municipality. The current and prior years' impact of this error has to be determined in order for a correction to be made.

14. No reconciliations were performed between water purchases and water sales, arising from a lack of controls over the completeness of water revenue and water losses for the year under review. I was unable to perform alternative audit procedures relating to testing the completeness of water revenue and water losses (technical losses).

15. Water meter reading sheets could not be provided during the audit, and those tested indicated an overstatement of R21 000 and an understatement of R69 000.

16. Certain electricity meter readings selected had not been accurately recorded on the system resulting in an understatement of revenue and debtors by R333 858.

17. Consequently, I did not obtain sufficient audit evidence to satisfy myself as to accuracy, completeness and cut-off of water revenue, water losses, consumer debtors and VAT.

### **Interest earned**

18. A comparison of the recorded interest earned of R1 871 987 to bank confirmations revealed that interest earned for the year was understated by R433 817. Consequently, I did not obtain sufficient audit evidence to satisfy myself as to accuracy, completeness and cut-off of interest earned.

## **Expenditure**

19. A duplicate expense of R2 000 000 and an error of R555 730 resulted in an overstatement of expenditure and trade creditors.
20. Various instances where expenses had been raised although the rights and obligations had not yet transferred to the municipality were highlighted by the audit and resulted in an overstatement of expenditure and creditors by R6 835 806.
21. Supporting documentation for expenditure to the value of R13 017 940 could not be provided for auditing.
22. Accordingly, I was unable to conclude on the accuracy, existence, classification and cut-off of expenditure and trade creditors.

## **Conditional grants**

23. The prior year audit report identified the following adjustments to conditional grants which continue to remain unresolved in the current year:

▪ Adjustment to receipts (credit)	R5 289 705
▪ Adjustments conditions met (debit)	R18 769 847
24. The municipality determined these adjustments based on the accuracy of the recorded fixed asset balance and accordingly, no supporting documentation was made available to support the accuracy of these adjustments.
25. The current year conditional grants expenditure of R126 796 530 as reflected in annexure 1 to the financial statements did not equal the amount transferred to grant income in the year under review, being R114 362 474 as disclosed in note 15.5 to the financial statements. The difference of R12 434 055 was described in note 15.5 as “transfer to counter funding” and explained as relating to funding made by the municipality towards projects as complete grants in respect of projects have not been received. However, adequate documentation to support this amount could not be provided.
26. Accordingly, I was unable to conclude on the completeness, accuracy, valuation, allocation, and obligations of the unspent conditional grants balance of R35 034 633.

## **Provisions**

27. The current year movement in the bonus provision was calculated at 15% of gross annual salary. However, in terms of performance contracts sighted the performance bonuses should be calculated as between 5% and 14% depending on key performance indicators. Accordingly, it would appear that the current year bonus provision was probably overstated.
28. Furthermore, the prior year provision of R407 000 was included in the closing balance. As a result of lacking supporting documents this amount could not be audited in the prior year. This matter therefore remained unresolved in the year under review.
29. Accordingly, I was unable to determine the accuracy and valuation of and rights and obligations relating to the performance bonus provision.

## **Consumer deposits**

30. I tested the reasonableness of the consumer deposits by re-computing the expected balance based on the number of customers and the required deposit. This comparison revealed a probable understatement in the range of between R1 009 162 and R9 947 962.
31. Accordingly, I was unable to determine the accuracy, completeness and valuation of the consumer deposits balance.

## **Creditors**

32. No reconciliations were performed between supplier statements and the trade creditors' balances per the general ledger. My comparison of material creditors' general ledger balances to the supplier statements revealed a net overstatement of the trade creditor balances by R674 090.
33. Supporting documentation as evidence for the sundry creditors' accrual account balance of R3 559 901 brought forward from prior years could not be provided for my audit.
34. Not all project contracts selected for auditing to test payments to retention creditors could be provided for my audit.
35. Accordingly, I was unable to determine the accuracy and completeness of and rights and obligations relating to creditors.

## **Consumer Debtors**

36. The consumer debtors listing balance of R61 633 195 differed from the recorded balance of R62 361 502. Management was unable to provide a reconciliation of the difference of R728 307.
37. Due consideration to the ongoing adequacy of the provision for bad debts was not given. The only movement in the bad debt provision from the prior year balance, was a bad debt write-off of R489 934. Management could not present an assessment of the adequacy of the provision for bad debts for the year under review.
38. Included in consumer debtors was a suspense account balance that contained unallocated receipts to the value of R 2 145 295. Until the nature of these deposits can be determined, the impact on the financial statements is unknown.
39. In addition, interest on long outstanding consumer debtor balances had not been levied and this resulted in an understatement of revenue and debtors. The entity does not have a well defined policy regarding the raising of interest on overdue accounts and accordingly, I was unable to estimate the impact of this error.
40. Consequently, I was unable to confirm or verify by alternative auditing procedures, the valuation, existence and completeness of consumer debtors totalling R27 213 440 reported on the balance sheet.

## **Other debtors**

41. Included in other debtors was an amount of R3 870 914 relating to the alleged fraud which had resulted in the misappropriation of municipal funds. Legal action had been taken in an attempt to

recover the misappropriated funds. However, no documentary evidence could be made available to support the recoverability of these funds.

42. Accordingly, I was unable to conclude on the appropriateness of the valuation of other debtors.

### **VAT**

43. Included in the VAT receivable of R18 657 201 is R16 499 713 which the municipality had raised relating to the under recovery of input VAT. No supporting documentation was made available to me and accordingly I was unable to test the validity, completeness and accuracy of the recorded VAT receivable.

### **Investments**

44. Investments as reflected in note 7 to the financial statements were incorrectly classified. The term deposit of R8 778 804 is redeemable on 31 March 2009 and accordingly should be reclassified to current assets. Moreover, the call account of R3 336 743 should be reclassified as cash and cash equivalents as it is redeemable within 90 days per the MFMA requirements.

### **Long-term liabilities**

45. A review of the loan agreement in respect of the ABSA loan indicated that the debt covenants in respect of the year-on-year increase in debtors not to exceed 15% had not been complied with. Therefore, the entity is in breach of the loan covenants and as a result the bank is entitled to call for the loan to be settled immediately. Accordingly, the loan balance of R5 594 810 included in the long term liabilities of R17 065 868 should be reclassified as current liabilities on the face of the statement of financial position.

### **Irregular expenditure**

46. The remuneration structures of certain councillors exceeded the limitations determined by Government Gazette R. 1227 (Termination of Upper Limits of Salaries, Allowances and Benefits of Different Members of Municipal Councils). This resulted in an overstatement of councillors' remuneration by R100 535.

### **Opinion**

#### **Disclaimer of opinion**

47. 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 Umkhanyakude District Municipality. Accordingly, I do not express an opinion on the financial statements.

#### **Emphasis of matters**

I draw attention to the following matter:

#### **Going concern**

48. The municipality's current liabilities exceeded its current assets by R39 295 551, in comparison to the prior year of R28 764 707 and there was a decrease in the bank balances of R4 641 737 in comparison to the prior year.

49. It was further noted that the balance sheet indicated a balance of R35 034 633 of unspent conditional grants, and yet the municipality only has approximately R12 115 547 in funds invested.
50. Because of the above the extent to which service delivery was achieved is questionable as the municipality is reliant on funding from provincial and national government.

### Unauthorised expenditure

51. I draw attention to the fact that the municipality exceeded its fixed asset additions budget of R106 906 433 by R197 219 579 as disclosed in note 27 to the financial statements; in compliance with section 125(2)(d) of the MFMA.

### OTHER MATTERS

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

#### Internal controls

52. 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 & communication	Monitoring
Accumulated surplus / Government grant reserve	✓		✓		
Revenue / VAT	✓		✓	✓	✓
Interest earned	✓		✓	✓	✓
Expenditure / Creditors	✓		✓		
Fixed assets	✓		✓		✓
Unspent conditional grants	✓		✓		
Provisions					✓
Consumer deposits			✓		✓
Creditors	✓		✓		✓
Debtors	✓		✓		✓
VAT	✓				
Investments	✓				
Long-term liabilities	✓				✓

Reporting item	Control environment	Risk assessment	Control activities	Information & communication	Monitoring
Irregular expenditure	✓				✓
<p><u>Control environment</u>: establishes the foundation for the internal control system by providing fundamental discipline and structure for financial reporting.</p> <p><u>Risk assessment</u>: involves the identification and analysis by management of relevant financial reporting risks to achieve predetermined financial reporting objectives.</p> <p><u>Control activities</u>: policies, procedures and practices that ensure that management's financial reporting objectives are achieved and financial reporting risk mitigation strategies are carried out.</p> <p><u>Information and communication</u>: 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.</p> <p><u>Monitoring</u>: 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.</p>					

## Non-compliance with applicable legislation

### ***Municipality Finance Management Act (MFMA)***

53. There was no supporting evidence that the reports, as required by section 71 of the MFMA, were submitted to the executive committee on a monthly basis.
54. There was no evidence of the mayor reviewing the budget as required by section 54(1) of the MFMA.
55. The municipality did not provide an approved budget as per section 71(1-5) of the MFMA.
56. According to the provincial treasury, the municipality did not submit all information required in terms of section 73 of the MFMA.
57. The municipality did not review the delegations for the current year, as required by section 79 of the MFMA.
58. The municipality did not have a tariff policy as required by section 62 of the MFMA.
59. An annual report had not been compiled for the prior year as required by section 121(4)(d) of the MFMA.

### ***Unemployment Insurance Contributions (UIF)***

60. Contrary to section 5 of the Unemployment Insurance Contributions Act, 2002 (Act No. 4 of 2002), deductions for unemployment remuneration were not effected against councillors' salaries.



## Matters of governance

61. 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:

Matter of governance	Yes	No
<b>Audit committee</b>		
<ul style="list-style-type: none"> <li>The Municipality had an audit committee in operation throughout the financial year.</li> </ul>	✓	
<ul style="list-style-type: none"> <li>The audit committee operates in accordance with approved, written terms of reference.</li> </ul>	✓	
<ul style="list-style-type: none"> <li>The audit committee substantially fulfilled its responsibilities for the year, as set out in section 166(2) of the MFMA.</li> </ul>	✓	
<b>Internal audit</b>		
<ul style="list-style-type: none"> <li>The municipality had an internal audit function in operation throughout the financial year.</li> </ul>	✓	
<ul style="list-style-type: none"> <li>The internal audit function operates in terms of an approved internal audit plan.</li> </ul>		✓
<ul style="list-style-type: none"> <li>The internal audit function substantially fulfilled its responsibilities for the year, as set out in section 165(2) of the MFMA.</li> </ul>		✓
<b>Other matters of governance</b>		
<ul style="list-style-type: none"> <li>The annual financial statements were submitted for audit as per the legislated deadlines in section 126 of the MFMA.</li> </ul>		✓
<ul style="list-style-type: none"> <li>The annual report was submitted to the auditor for consideration prior to the date of the auditor's report.</li> </ul>		✓
<ul style="list-style-type: none"> <li>The financial statements submitted for audit were not subject to any material amendments resulting from the audit.</li> </ul>		✓
<ul style="list-style-type: none"> <li>No significant difficulties were experienced during the audit concerning delays or the unavailability of expected information and/or the unavailability of senior management.</li> </ul>		✓
<ul style="list-style-type: none"> <li>The prior year's external audit recommendations have been substantially implemented.</li> </ul>		✓
<b>Implementation of Standards of Generally Recognised Accounting Practice (GRAP)</b>		
<ul style="list-style-type: none"> <li>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.</li> </ul>	✓	
<ul style="list-style-type: none"> <li>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.</li> </ul>	✓	
<ul style="list-style-type: none"> <li>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.</li> </ul>		✓

## **Unaudited supplementary schedules**

62. The municipality provided supplementary information in the financial statements on whether resources were obtained and used in accordance with the legally adopted budget in accordance with GRAP1 Presentation of Financial Statements. The supplementary budget information set out in appendices E1 and E2 does not form part of the financial statements and is presented as additional information. Accordingly I do not express an opinion on this.
63. The supplementary information set out in appendices A to D and F does not form part of the financial statements and is presented as additional information. I have not audited these schedules and accordingly I do not express an opinion thereon.

## **OTHER REPORTING RESPONSIBILITIES**

### **REPORT ON PERFORMANCE INFORMATION**

64. I was engaged to review the performance information.

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

65. 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**

66. 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.
67. 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.
68. 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)**

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

69. The municipality did not conduct any performance reviews and quarterly reviews of the Performance Audit Committee. This is in contravention of sections 41, 34(b) and 29 of the MSA.

#### **Performance information not received in time**

70. The municipality did not submit an annual performance report for the year ended 30 June 2008 as required by section 127(1) of the MFMA and section 46 of the MSA and could therefore not be audited at the date of my report.

## **OTHER REPORTS**

### **Investigations**

#### **Alleged misappropriation of funds**

71. There was an un-reconciled amount of R6.1m on the 2005/06 bank reconciliation as a result of alleged misappropriation of funds. As at 30 June 2008, R3.6m was still outstanding. At the date of finalising the report, criminal charges had been raised against those involved of which the outcome was not known.

### **APPRECIATION**

72. The assistance rendered by the staff of the Umkhanyakude District Municipality during the audit is sincerely appreciated.

Pietermaritzburg

9 December 2008



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