

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

**REPORT ON THE FINANCIAL STATEMENTS**

**Introduction**

1. I have audited the accompanying financial statements of the Mquma Local Municipality which comprise the statement of financial position as at 30 June 2008 statement of financial performance, statement of changes in net assets/equity 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 basis of accounting determined by the National Treasury, as set out in accounting policy note 1 and in the manner required by the Local Government: Municipal Finance Management Act, 2003 (Act No. 56 of 2003) (MFMA) 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. 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 Mngquma Local 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 adverse opinion**

#### **Basis of presentation**

10. In terms of section 3(1) of Government Notice No. 522 issued in Government Gazette No. 30013 of 29 June 2007, medium capacity municipalities are exempt from complying with section 122(3) of the MFMA to the extent that they are required in the preparation of their financial statements to comply with the standards referred to in that section.

Section 3(2) further states that:

- (a) Medium capacity municipalities must prepare and submit their financial statements for the 2006-07 and 2007-08 financial years on the same basis that they prepared their 2005-06 annual financial statements.
  - (b) No medium capacity municipality may deviate from section 3 (2) (a) above or from the exemption in terms of sub clause (1) (b) above unless the municipality has consulted the relevant treasury before 31 July of the year concerned and has agreed with treasury on the basis of presentation of the annual financial statements.
  - (c) Any agreement referred to in paragraph b must be in writing and submitted to National Treasury before 15 August of the relevant year.
11. The municipality prepared their 2005-06 financial statements on the entity specific basis of accounting determined by the Institute of Municipal Finance Officers (IMFO). The current and prior period financial statements have been prepared using standards of GRAP and GAMAP. Therefore the municipality has early adopted the standards of GRAP and GAMAP without complying with the above paragraphs of the Government Notice in that the approval to early adopt obtained by the municipality was obtained after the legislated dates.
  12. Furthermore the municipality's basis of presentation as per the financial statements is GRAP and GAMAP and there is no mention of SA GAAP. The basis of

presentation also does not mention which exemptions were utilized for me to establish on which alternative basis of presentation the financial statements were prepared.

13. Consequently, I was unable to determine the municipality's basis of presentation.

14. In light of the above, modified GRAP, GAMAP and GAAP was assumed to be the applicable accounting framework.

### **Receivables**

15. A prior period adjustment of R25.6 million to the opening balance of receivables has been recorded directly against accumulated surplus. A further adjustment of R2.9 million was also recorded to remove an amount disclosed as Other receivable, from the statement of financial position. The municipality was not able to provide supporting documentation for these adjustments.

16. Adequate explanations could not be provided for the existence of credit balances in receivables of R4.1 million as reflected on the receivables age analysis.

17. Journals passed against receivables amounting to R774 000 were not supported by adequate documentation.

18. The municipality's records and systems did not permit the application of alternative audit procedures. Consequently, I was unable to satisfy myself as to the existence, completeness, valuation and disclosure of receivables in note 9 to the annual financial statements.

19. The policy of the municipality is to provide for doubtful debts. An assessment of the provision for doubtful debts of R26.9 million as disclosed in note 9 to the annual financial statements showed that capitalised receivables, which have been in arrears in excess of 2 years, have not been provided for.

In addition, the provision for doubtful debts of R105.5 million which was raised in the previous year relating to the capitalised receivables was reversed directly to the accumulated surplus, instead of being recognised in the statement of financial performance as required by IAS39.65. The accumulated surplus is overstated by R105.5 million, the provision for doubtful debts is understated by R89.5 million and the reversal of impairment losses is understated by R16 million.

20. The municipality has not presented a summary of receivables by customer classification as required by GRAP. This fact has been noted in the annual financial statements. In addition, the ageing is incomplete as it does not include the receivables for rentals and the so-called capitalised debtors.

21. Changes in property ownership are not effected on the receivables age analysis and previous owners of property are still charged for assessments rates and service charges after the property has been sold.

### **Property, plant and equipment**

22. The fixed asset register did not contain sufficient information describing the assets as well as the location of the assets to enable verification of the existence thereof. The asset register is maintained on a spreadsheet which does not record an adequate audit trail of changes that have been made. Disposals are not recorded on the asset register when they occur. Furthermore, the asset register did not reconcile to the trial balance. The cost and accumulated depreciation recorded in the annual financial statements did not reconcile to the trial balance.

23. The municipality was unable to provide copies of title deeds for all fixed property recorded on the fixed asset register, and it was not possible to trace all fixed property to the original title deeds. Such property has also been recorded in the fixed asset register at R1 instead of the fair value as required by GAMAP17.
24. A prior period adjustment of R6.9 million for the incorrect depreciation of land was recorded against accumulated surplus. The municipality was unable to provide adequate supporting documentation for the adjustment.
25. The municipality's records and systems did not permit the application of alternative audit procedures. Consequently, I was unable to satisfy myself as to the valuation, accuracy, existence, completeness and rights pertaining to ownership of assets of the municipality to the value of R56.7 million as disclosed in the statement of financial position.

#### **Inventory**

26. The municipality was unable to provide adequate supporting documentation for a journal of R4.2 million which was passed during the preparation of the annual financial statements. Adequate explanations could not be provided for the movement in inventory between the current and the prior financial periods. Obsolete inventory of R82 000 was written off to current liabilities.
27. The municipality's records and systems did not allow the application of alternative audit procedures. As a result, I was unable to determine the existence and valuation of inventory of R2.1 million disclosed in note 8 to the annual financial statements.

#### **Finance leases**

28. The municipality did not provide a copy of the lease statement reflecting the outstanding balance on the finance lease which commenced during the current year. As an alternative, the lease agreements were obtained and an amortisation table was compiled. The output VAT of R100 011, which has been claimed from SARS, has not been recorded in the general ledger. The long-term portion of the lease liability of R517 699 disclosed in note 1 to the annual financial statements is understated by R6 658, while the short-term portion of the long-term loan is understated by R130 531. The interest expense disclosed in the statement of financial performance is understated by R23 863.
29. IAS17.20 requires the municipality to disclose the future minimum lease payments to be incurred. This disclosure has not been made in the annual financial statements.

#### **Payables**

30. The municipality was unable to provide supporting documentation for the amount disclosed as staff loans – third party payments of R2.3 million in note 4 to the annual financial statements.
31. The accruals listing provided did not reconcile to the trial balance and was found to differ by R12 685.
32. The unspent conditional grant liability of R14.5 million disclosed in note 5 to the annual financial statements could not be reconciled to supporting documentation. Recalculation of the amount showed a difference of R7.8 million which could not be adequately explained. Furthermore, the difference of R2.2 million between the

amounts released to revenue disclosed in notes 18 and 18.2 could not be adequately explained.

33. IAS19.10 (Employee benefits) requires the disclosure of other short-term employee benefits when an employee has rendered a service to the municipality as the undiscounted amount expected to be paid for that service. The municipality has not recognised a payable for the accrued bonus payable.
34. I was unable to perform any satisfactory alternative audit procedures, and as a result, I was unable to determine the completeness and valuation of creditors and unspent conditional grants disclosed in notes 4 and 5 to the annual financial statements.

### **Revenue**

35. The municipality has not performed a reconciliation between the valuation roll and assessment rates revenue recognised in the statement of financial performance. The municipality was unable to provide adequate explanations for the variances between current year amounts, prior year amounts and budgeted amounts. A recalculation of the billings for the year showed that amounts billed have not been accurately recorded in the statement of financial performance. A recalculation of estimated billings for the year showed that not all amounts have been billed. It was not possible to determine the completeness of revenue as the sequence order of receipts could not be established.
36. A prior period adjustment of R4.2 million to revenue was recorded directly against accumulated surplus. The municipality was unable to provide supporting documentation for this adjustment, and as a result, I was unable to determine the occurrence and accuracy of revenue.
37. Interest receivable of R19 650 has not been recorded in the statement of financial performance. As a result, revenue and accrued income is understated by this amount. Furthermore, revenue from interest, other income and gains from disposal of property, plant and equipment disclosed in the statement of financial performance did not reconcile to the trial balance.
38. Adequate supporting documentation was not provided for debit transactions posted to revenue amounting to R828 000.
39. The municipality's records and systems did not allow the application of alternative audit procedures, and as a result, I was unable to determine the completeness, accuracy and occurrence of revenue of R104.2 million disclosed on the face of the statement of financial performance.

### **Employee related costs**

40. The municipality was unable to provide adequate explanations for the movements in compensation of employees when comparing the current year to the prior year and to the budgeted amounts. Furthermore, the annual financial statements did not agree to the trial balance and was found to differ by R99 195.

### **Operating leases**

41. The municipality currently leases a building for office accommodation under an operating lease. The value of the lease payments have not been smoothed over the period of the lease as required by IAS17.33. In addition, the disclosure of the value of the minimum lease payments as required by IAS17 has not been made. It was not possible to perform alternative procedures to determine the correct disclosures as the municipality was unable to provide a copy of the lease agreement.
42. As a result of the above, it was not possible, even through the application of alternative audit procedures, to determine the accuracy and completeness of amounts and disclosure of operating leases.

### **Funds and reserves**

43. Transfers between the accumulated surplus and the government grant reserve to reflect the additions and depreciation of assets purchased with grants have not been effected on the trial balance. Nevertheless, the transfers are reflected on the statement of changes in net assets. As a result, there is a difference between the annual financial statements and the trial balance of R22.9 million. In addition, a difference of R267 000 was noted between the accumulated surplus disclosed on the statement of changes in equity and the trial balance.
44. I was unable to perform any satisfactory alternative audit procedures. Consequently, I was unable to determine the accuracy of the funds and reserves disclosed in the statement of changes in equity.

### **Provisions**

45. The Municipality, which operates landfill sites, has an obligation in terms of section 28 of the National Environment Management Act, 1998 (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.
46. The provision for leave of R7 million disclosed in note 3 to the annual financial statements is based on the leave records of the municipality, which were found to be inadequate. Instances were found where leave recorded as taken was not supported by leave applications and documentation authorising the absence from work. Attendance registers for some employees were not submitted.  
Employee's who were no longer employed by the municipality and had already received their leave payouts were included in the calculation of the provision. Some employees have accrued leave balances in excess of 48 days, which is not allowed in terms of the collective agreement with the South African Local Government Bargaining Council. The municipality's records and systems did not permit the application of alternative audit procedures. Consequently, I was unable to satisfy myself as to the accuracy and valuation of the provision for leave of R7 million as disclosed in note 3 to the annual financial statements.  
In addition, a prior period adjustment to the provision for leave was recorded directly against accumulated surplus, with the result that the amount for the current and prior

periods is the same. It was not possible to determine the accuracy of the prior period amount.

47. GAMAP19.14 defines a provision as a liability of uncertain timing or amount. The municipality has recognised a provision for performance bonus of R1.2 million in note 3 to the annual financial statements. The municipality has not fully implemented the performance management system, and as disclosed in note 3 to the annual financial statements, there is no present obligation to pay a performance bonus. The amount should not be disclosed as a provision, but rather as a contingent liability. As a result, provisions disclosed in the statement of financial position are overstated by R1.2 million, employee costs disclosed in the statement of financial performance are overstated by R502 161 and the accumulated surplus is overstated by R687 755.

#### **Cash and cash equivalents**

48. A prior period adjustment of R6.8 million to correct the opening balances of the bank account was recognised directly against the accumulated surplus. The municipality was unable to provide adequate supporting documentation, and as a result, it was not possible to determine the valuation of cash and cash equivalents.

#### **Contingent liabilities**

49. The municipality has been named as a respondent in a defamation case which was lodged subsequent to year end. The details have not been disclosed in a note to the annual financial statements as required by GAMAP19.

#### **Consumer deposits**

50. In terms of Government Notice 591 published in Government Gazette 28931 of 15 June 2008, all the assets, rights, liabilities and obligations relating to the provision of water and sanitation services were to have been returned to Amathole District Municipality.

Consumer deposits of R317 227 are disclosed in note 2 to the annual financial statements. This is in contravention of the above regulation, and the amounts should be transferred to Amathole District Municipality. Due to the above, consumer deposits is overstated by R317 227 and the accumulated surplus is understated by the same amount.

51. A prior period adjustment of R1.8 million to correct the opening balance of consumer deposits was recorded directly against accumulated surplus. The municipality was unable to provide adequate supporting document for the transaction, and as a result, I was unable to determine the accuracy of the prior period amount disclosed as consumer deposits.

#### **Value Added Tax**

52. Section 7(1) of the Value Added Tax Act, 1991 (Act No. 89 of 1991) states that VAT must be declared on the supply by any vendor of goods or services in the course or furtherance of any enterprise. The municipality was unable to confirm whether output VAT has been declared on commission earned for processing eNatis transactions on behalf of the Department of Transport.
53. According to the South African Revenue Services, the municipality is registered for VAT. VAT reconciliations have not been performed by the municipality for the year under review. In addition, due to the inability to satisfactorily audit VAT I am unable

to determine the value of any adjustments required to affect transactions including expenses, revenue, purchases and disposals of property, plant and equipment.

54. As a result, the valuation and completeness of the receivable for VAT could not be determined.

#### **Unauthorised expenditure**

55. Section 1 of the MFMA defines unauthorised expenditure as overspending of the total amount appropriated for a vote in the approved budget. Appendix E to the annual financial statements discloses the budget of the Speaker's office as R9.3 million while the amount expended during the current year is R10 million. The difference of R714 324 has not been disclosed as unauthorised expenditure.

#### **Irregular expenditure**

56. Section 20 of the municipality's supply chain management policy requires that for purchases in excess of R2 000, at least three quotes should be obtained. If three quotes are not obtained, the reason for this should be recorded. Expenditure amounting to R208 540 did not have the required number of quotes and is considered to be irregular.

57. A payment voucher for R430 619 was not approved by the municipal manager or an appropriately delegated official. This amount is considered to be irregular.

#### **Fruitless and wasteful expenditure**

58. Fruitless and wasteful expenditure is defined in section 1 of the MFMA as expenditure which was made in vain and could have been avoided had reasonable care been exercised. The municipality incurred interest expenditure which it did not budget for amounting to R238 000.

#### **Opinion**

##### **Adverse opinion**

59. In my opinion, because of the significance of the matter(s) described in the Basis for adverse opinion paragraph(s), the financial statements do not present fairly, in all material respects, the financial position of the Mngquma Local Municipality as at 30 June 2008 and its financial performance and cash flows for the year then ended, in accordance with the basis of accounting and in the manner required by the MFMA and DoRA.

##### **Emphasis of matter**

I draw attention to the following matter:

##### **Going concern**

60. The statement of financial position reflects a surplus for the year and the statement of financial position reflects a net asset position. If the financial statements were adjusted to reflect the fair value of receivables, a deficit would have been recorded and the municipality would be in a net liability position. These matters are highlighted as going concern risks, and were it not for the continued support of central government, it is uncertain whether the municipality would be able to continue operating as a going concern in the foreseeable future.



## OTHER MATTER(S)

I draw attention to the following matter(s) that relate to my responsibilities in the audit of the financial statements:

### Internal controls

61. 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
Basis of preparation	X				
Receivables			X		
Property, plant and equipment			X		
Inventory			X		
Finance leases					
Payables			X		X
Revenue			X		
Employee related costs					X
Operating leases			X		
Funds and reserves			X		
Provisions			X		
Cash and cash equivalents			X		
Contingent liabilities			X		
Consumer deposits			X		
Value added tax			X		
Unauthorised expenditure					X
Irregular expenditure			X		
Fruitless and wasteful expenditure			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.

Reporting item	Control environment	Risk assessment	Control activities	Information and communication	Monitoring
<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.					
<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 allows people to carry out their financial reporting duties.					
<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.					

### **Non-compliance with applicable legislation**

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

62. A performance agreement was not concluded between the council and the municipal manager as required by section 57 of the act.

#### **Municipal Finance Management Act**

63. Regulation 4 and 5 issued in terms of the act requires that delegations are determined for supply chain management purposes. This has not been done by the municipality and it continues to use delegations which were approved prior to the introduction of supply chain management.
64. Creditors were not settled within 30 days as required by section 65(2)(e) of the act.

#### **Remuneration of Political Office Bearers Act, 1998 (Act No. 20 of 1998)**

65. A salary increment implemented in January 2008 and backdated to July 2007 resulted in two full time executive members of the mayoral committee being paid the same salary as the speaker of the council. This is in contravention of paragraph 5 of Notice No. R. 1227 of the Government Gazette 30600 issued on 18 December 2007
66. The council approved an increase of 5.4% by means of a council resolution as required by section 7(3) of the act. The actual increase granted was 7.5%, but a council resolution was not passed for the additional amount.

#### **Matters of governance**

67. 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>Audit committee</b>	<b>Yes</b>	<b>No</b>
<ul style="list-style-type: none"> <li>The municipality had an audit committee in operation throughout the financial year.</li> </ul>		X
<ul style="list-style-type: none"> <li>The audit committee operates in accordance with approved, written terms of reference.</li> </ul>		X
<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>		X
<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>		X
<ul style="list-style-type: none"> <li>The internal audit function operates in terms of an approved internal audit plan.</li> </ul>		X
<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>		X
<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>	X	
<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>		X
<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>		X
<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>		X
<ul style="list-style-type: none"> <li>The prior year's external audit recommendations have been substantially implemented.</li> </ul>	X	
<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>		X
<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>		X
<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>		X

## **Unaudited supplementary schedules**

68. The supplementary information set out on pages X to X does not form part of the financial statements and is presented as additional information. I have not audited this/these schedule(s) and accordingly I do not express an opinion thereon.

## **OTHER REPORTING RESPONSIBILITIES**

### **REPORT ON PERFORMANCE INFORMATION**

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

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

70. 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**

71. 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.

72. 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.

73. 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**

74. In terms of regulation 10 of the Municipal Planning and Performance Management Regulations, the following general key performance indicators are prescribed in terms of section 43 of the Municipal Systems Act no 32 of 2000:

- The percentage of households with access to basic level of water, sanitation, electricity and solid waste removal;
- The percentage of households earning less than R1100 per month with access to free basic services;
- The percentage of a municipality's capital budget actually spent on capital projects identified for a particular financial year in terms of the municipality's integrated development plan;
- The number of jobs created through municipality's local economic development initiatives including capital projects;
- The number of people from employment equity target groups employed in the three highest levels of management in compliance with a municipality's approved employment equity plan;

- The percentage of a municipality's budget actually spent on implementing its workplace skills plan.

Audit work performed revealed that none of the Key Performance Indicators (KPIs) per the IDP and the annual performance reports are in line with the general KPIs prescribed by section 43 of the municipal systems act and listed in regulation 10 of the municipal planning and performance management regulations.

75. In terms regulation 14(2)(a) of the Municipal Planning and Performance Management Regulations, 2001, a municipality must annually appoint and budget for a performance audit committee consisting of at least three members, the majority of which may not be involved in the municipality as a councillor or an employee.

It was found that the municipality has not appointed a performance audit committee and has not elected to utilise the audit committee to fulfil the functions of the performance audit committee

**Objectives/indicators/targets reported in annual report, but not predetermined as per strategic/corporate/annual performance/integrated development plan and/or budget**

76. The budget is not aligned to the Integrated Development Plan of the municipality. This is due to the fact none of the development objectives or priorities per the IDP and Performance report could be traced to the municipality's budget.

**Lack of sufficient appropriate audit evidence**

77. I was unable to obtain sufficient appropriate audit evidence in relation to the performance information of the Mngquma Local Municipality, as I was unable to obtain access to the following records pertaining to the programmes/objectives/key performance indicators:

Infrastructure Directorate

- The council approval of the extension of the validation process.
- Training report.
- Feasibility study report.
- Applications submitted to TET for consideration.
- Attendance registers signed by Centane community members and councillors who attended the workshop.
- Signed appointment letter of the service provider appointed to provide these workshops to the community and councillors and contract between this service provider and Mngquma.
- Document containing the content of the workshop.

Corporate services: Directorate

- Accountability agreements.
- Correspondence generated to the responsible directorate to attend to the physical resources, such as offices to ensure that there is compliance with the Employment Equity Act.

- Personnel files with appointment letters for all the interns appointed to boost HR capacity

### **OTHER REPORTS**

78. A forensic investigation is currently underway to probe the receivables and billing of customers, as the municipality is suspicious of fraudulent activity taking place. A second investigation is being conducted into the expenditure from the Municipal Infrastructure Grant for the years 2004 to 2006, including amounts that were expended for the construction of roads. These investigations are both ongoing as at the reporting date.

### **APPRECIATION**

79. The assistance rendered by the staff of the Mngquma Local Municipality during the audit is sincerely appreciated.

*Auditor-General*

East London

18 December 2008



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

**REPORT OF THE AUDITOR-GENERAL TO THE EASTERN CAPE PROVINCIAL LEGISLATURE AND THE COUNCIL ON THE FINANCIAL STATEMENTS AND PERFORMANCE INFORMATION OF THE MNQUMA LOCAL MUNICIPALITY FOR THE YEAR ENDED 30 JUNE 2009**

**REPORT ON THE FINANCIAL STATEMENTS**

**Introduction**

1. I was engaged to audit the accompanying financial statements of the Mquma Local Municipality which comprise the statement of financial position as at 30 June 2009, and the statement of financial performance, the statement of changes in net assets and the 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].

**The accounting officer's responsibility for the financial statements**

2. The accounting officer is responsible for the preparation and fair presentation of these financial statements in accordance with the Statements of Generally Recognised Accounting Practice (Statements of GRAP) and in the manner required by the Local Government: Municipal Finance Management Act, 2003 (Act No. 56 of 2003) (MFMA) and for such internal control as the accounting officer determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud and error.

**The Auditor-General's responsibility**

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 the 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 described 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 for disclaimer of opinion**

**Consumer debtors**

4. Consumer debtors were disclosed at R13,4 million on the face of the statement of financial position and note 9 to the annual financial statements. This amount does not agree to the underlying, debtors age analysis and debtors listing by an unexplained and unreconciled difference of R6,8 million and R2,7 million respectively. Furthermore, included in the debtors balance are debtors with credit balances to the amount of R2,5 million, as a result payables is understated by the same amount.
5. In addition material breaches in the access controls safeguarding the debtors sub-ledger, resulted in an unquantifiable amount of debtors being removed without the debtor making payment. Even through alternative procedures, I was unable to confirm the exact amount of debtors removed from the accounting system.
6. Due to limitations placed on the scope of my work and municipal records not permitting the application of alternative audit procedures, I could not obtain sufficient appropriate

evidence to confirm that consumer debtors were recorded and if those recorded were at the correct amount.

### **Creditors**

7. I was unable to satisfy myself, even after performing alternative procedures, that the trade creditors of R13,1 million included in the trade and other payables disclosed in the statement of financial position included all amounts due to suppliers at year end and that creditors were recorded at the correct amount. This was as a result of trade creditors not supported by adequate documentation. In addition, the municipality did not prepare supplier reconciliations and did not have an adequate alternative system of ensuring that all goods and services received prior to year-end, but not yet paid, were accrued.

### **Unspent conditional grants and receipts**

8. Unspent conditional grants and receipts are disclosed at R9,4 million on the face of the statement of financial position and note 5 to the annual financial statements. The unspent conditional grants are not supported by bank balances to the amount of R2 million and I am unable to determine if this amount was utilised for the purposes that it was intended for.

### **Accumulated surplus**

9. Included in accumulated surplus disclosed at R114,4 million in the statement of financial position is a journal to the amount of R2,2 million. Management was unable to provide documentation or explanations in support of this journal.

### **Revenue**

#### **Property rates**

10. Due to duplicate processing and inadequate supporting documentation to journals the property rates revenue and debtors are overstated by R9,4 million. Properties in the municipal district and under the control of the municipality were not valued for property rates purposes and therefore not included in the valuation roll on which the property rates assessments were based. I was therefore unable to determine, even after performing alternative procedures, that all rates revenue that should have been billed and included in the property rates revenue of R29 million is disclosed in the statement of financial performance.

#### **Service charges**

11. I was unable to satisfy myself, even after performing alternative procedures, that service charges of R6,7 million disclosed in note 14 to the financial statements included all amounts due from consumers at year end and that service charges were recorded at the correct amounts. This was as a result of the incorrect updating of the tariffs charged for refuse removal and fire levy on the billing system and this not agreeing to the approved tariff policy.



#### Rental of facilities and equipment

12. Income from the rental of facilities and equipment is disclosed at R2,9 million in note 15 to the annual financial statements. Management was unable to provide schedules and documentation in support of this balance.

#### Interest earned – outstanding debtors

13. Interest earned on outstanding debtors is disclosed at R1,1 million on the face of the statement of financial performance and note 16 to the annual financial statements. Incorrect updating of the billing system, resulted in the interest rates charged not agreeing to the council approved interest policy. In the absence of adequate and reliable supporting documentation I was unable to quantify the extent of the lost interest revenue generated and debtors not accounted for.

#### Value Added Taxation (VAT)

14. VAT is disclosed at R719,565 in note 10 to the annual financial statements. Management could not provide explanations or reconciliations to support reasons for the understatement of disclosure when compared to the correspondence from the South African Revenue Services (SARS) and the underlying accounting records to the amount of R3,3 million and R1,3 million respectively.
15. In addition, my re-computation of VAT noted that the accounting officer did not claim VAT input credits to the amount of R2,3 million. A query regarding the validity of the apportionment percentage used to calculate input credits and the invoices claimed for VAT to the amount of R752,876 is pending from SARS.
16. Consequently, I could not gather sufficient appropriate evidence to confirm that the VAT debtor is disclosed at the correct amount.

#### Bank overdraft

17. Bank overdraft was disclosed at R5,7 million on the face of the statement of financial position. Incorrect processing of transactions in the general ledger resulted in the general ledger balance not agreeing with the cash book by an amount of R571,194. In addition the bank overdraft was overstated by R496,327 as a result of the untimely clearing of the bank suspense accounts and the non reversal of stale cheques.
18. Consequently I could not gather sufficient appropriate evidence to confirm that the bank overdraft is disclosed at the correct amount.

#### Capital Commitments

19. Capital commitments were disclosed at R28,9 million in note 32 to the annual financial statements. Management was unable to provide adequate supporting documentation in support of this balance.
20. Due to limitations placed on the scope of my work and municipal records not permitting the application of alternative audit procedures, I could not gather sufficient appropriate evidence to confirm that commitments were disclosed at the correct amount and if all commitments were recorded.

### **Retirement benefit information**

21. Note 33 to the annual financial statements paraphrased reads "All employees belong to 4 defined benefit retirement funds and that councillors belong to 1 defined benefit retirement fund." Contrary to the prescripts of IAS 19, *Employee benefits*, the accounting officer did not disclose the actuarial valuation of the municipality's obligation towards each of these funds.
22. Due to limitations placed on the scope of my work and municipal records not permitting the application of alternative audit procedures, I could not determine the effect of retirement benefit information on the annual financial statements.

### **Employee related costs**

23. Employee related costs are disclosed at R52,1 million on the face of the statement of financial performance and note 20 to the annual financial statements. The disclosure is overstated when compared to the payroll by an unreconciled difference of R1,3 million. In addition, management could not provide reasons to support the salary control account disclosed at R2,7 million as a payable in note 4 to the annual financial statements.
24. Due to limitations placed on the scope of my work and municipal records not permitting the application of alternative audit procedures, I could not confirm that employee related costs were recorded at the correct amounts.

### **Cash flow statement**

25. The cash flow statement prepared by the municipality is misstated by R43,9 million due to incorrect amounts disclosed under cash generated by operations. The extent of the misstatement is due to the non-cash write off of bad debts.

### **Disclaimer of opinion**

26. 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. Accordingly, I do not express an opinion on the financial statements.

### **Emphasis of matters**

I draw attention to the following matters:

### **Going concern**

27. As at the reporting date the municipality's total current liabilities exceeded its total current assets by R7,8 million. I noted that the municipality had experienced substantial difficulty in recovering its debtors and furthermore, the municipality depends largely on the state for assistance for its continued existence.

### **Restatement of corresponding figures**

28. As disclosed in note 27 to the financial statements, the corresponding figures for 30 June 2008 have been restated by a net amount of R11,3 million as a result of errors discovered during the current and prior financial year.

### **Other matters**

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

### **Unaudited supplementary schedules**

29. The supplementary information set out in pages XX to XX do 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.

### **Non-compliance with applicable legislation**

#### **Municipal Finance Management Act, 2003 (Act No. 56 of 2003) (MFMA)**

30. The municipality did not make all payments to creditors within 30 days of receipt of the invoice as required by section 65(2)(e) of the MFMA.

#### **Environment Conservation Act, 1989 (Act No 73 of 1989)**

31. Section 20(1)(a) of the act states that "No person shall establish, provide or operate any disposal site without a permit issued by the Minister of Water Affairs and that the Minister may issue a permit subject to such conditions as he may deem fit." Permit were not issued for the municipality's landfill sites located in Butterworth, Centane and Ngqamakwe.

### **Governance framework**

32. The governance principles that impact the auditor's opinion on the financial statements are related to the responsibilities and practices exercised by the accounting officer and executive management and are reflected in the internal control deficiencies and key governance responsibilities addressed below:

### **Internal control deficiencies**

33. 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 deficiencies 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. (The number listed per component can be followed with the legend below the table.) In some instances deficiencies exist in more than one internal control component.

Par. no.	Basis for disclaimer of opinion	CE	RA	CA	IC	M
4	Consumer debtors	1				
7	Creditors			3		3
10	Unspent conditional grants and receipts					3
12	Accumulated surplus					1
14	Revenue	1		5		1
20	VAT					1
23	Bank overdraft					1
25	Capital commitments					1
27	Retirement benefit funds	1				
29	Related party transactions	1				
31	Employee related costs			3		
33	Cash flow statement			3		

34. The leadership of the municipality did not impose punitive action on officials found guilty of non-compliance with the established internal control policies and procedures, especially in the area of consumer debtors, unspent conditional grants, VAT, revenue and capital commitments.
35. Furthermore, a proper accounting system to deal with the complexities of the transition from fund accounting to accrual accounting was not in place to ensure that the information disclosed in the financial statements are accurate and complete.
36. Insufficient management oversight and the lack of accountability resulted in an abnormal amount of transactions being incorrectly classified, recorded in the incorrect periods and not being supported by an adequate audit trail.

<b>Legend</b>	
<b>CE = Control environment</b>	
The organisational structure does not address areas of responsibility and lines of reporting to support effective control over financial reporting.	1
Management and staff are not assigned appropriate levels of authority and responsibility to facilitate control over financial reporting.	2
Human resource policies do not facilitate effective recruitment and training, disciplining and supervision of personnel.	3
Integrity and ethical values have not been developed and are not understood to set the standard for financial reporting.	4
The accounting officer/accounting authority does not exercise oversight responsibility over financial reporting and internal control.	5
Management's philosophy and operating style do not promote effective control over financial reporting.	6
The entity does not have individuals competent in financial reporting and related matters.	7
<b>RA = Risk assessment</b>	
Management has not specified financial reporting objectives to enable the identification of risks to reliable financial reporting.	1
The entity does not identify risks to the achievement of financial reporting objectives.	2
The entity does not analyse the likelihood and impact of the risks identified.	3

The entity does not determine a risk strategy/action plan to manage identified risks.	4
The potential for material misstatement due to fraud is not considered.	5
<b>CA = Control activities</b>	
There is inadequate segregation of duties to prevent fraudulent data and asset misappropriation.	1
General information technology controls have not been designed to maintain the integrity of the information system and the security of the data.	2
Manual or automated controls are not designed to ensure that the transactions have occurred, are authorised, and are completely and accurately processed.	3
Actions are not taken to address risks to the achievement of financial reporting objectives.	4
Control activities are not selected and developed to mitigate risks over financial reporting.	5
Policies and procedures related to financial reporting are not established and communicated.	6
Realistic targets are not set for financial performance measures, which are in turn not linked to an effective reward system.	7
<b>IC = Information and communication</b>	
Pertinent information is not identified and captured in a form and time frame to support financial reporting.	1
Information required to implement internal control is not available to personnel to enable internal control responsibilities.	2
Communications do not enable and support the understanding and execution of internal control processes and responsibilities by personnel.	3
<b>M = Monitoring</b>	
Ongoing monitoring and supervision are not undertaken to enable an assessment of the effectiveness of internal control over financial reporting.	1
Neither reviews by internal audit or the audit committee nor self -assessments are evident.	2
Internal control deficiencies are not identified and communicated in a timely manner to allow for corrective action to be taken.	3

### Key governance responsibilities

37. 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 key governance responsibilities, which I have assessed as follows:

No.	Matter	Y	N
<b>Clear trail of supporting documentation that is easily available and provided in a timely manner</b>			
1.	No significant difficulties were experienced during the audit concerning delays or the availability of requested information.		✓
<b>Quality of financial statements and related management information</b>			
2.	The financial statements were not subject to any material amendments resulting from the audit.		✓
3.	The annual report was submitted for consideration prior to the tabling of the auditor's report.	✓	
<b>Timeliness of financial statements and management information</b>			
4.	The annual financial statements were submitted for auditing as per the legislated deadlines [section 126 of the MFMA].	✓	
<b>Availability of key officials during audit</b>			
5.	Key officials were available throughout the audit process.	✓	
<b>Development and compliance with risk management, effective internal control and governance practices</b>			
6.	Audit committee		

No.	Matter	Y	N
	<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>		✓
7.	Internal audit		
	<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>		✓
8.	There are no significant deficiencies in the design and implementation of internal control in respect of financial and risk management.		✓
9.	There are no significant deficiencies in the design and implementation of internal control in respect of compliance with applicable laws and regulations.		✓
10.	The information systems were appropriate to facilitate the preparation of the financial statements.		✓
11.	A risk assessment was conducted on a regular basis and a risk management strategy, which includes a fraud prevention plan, is documented and used as set out in section 95(c)(i) of the MFMA.		✓
12.	Delegations of responsibility are in place, as set out in section 106 of the MFMA.	✓	
<b>Follow-up audit findings</b>			
13.	The prior year audit findings have been substantially addressed.		✓
<b>Issues relating to the reporting of performance information</b>			
14.	The information systems were appropriate to facilitate the preparation of a performance report that is accurate and complete.		✓
15.	Adequate control processes and procedures are designed and implemented to ensure the accuracy and completeness of reported performance information.		✓
16.	A strategic plan was prepared and approved for the financial year under review for purposes of monitoring the performance in relation to the budget and delivery by the Mnquma Local Municipality against its mandate, predetermined objectives, outputs, indicators and targets in terms of section 87 of the MFMA.		✓
17.	There is a functioning performance management system and performance bonuses are only paid after proper assessment and approval by those charged with governance.		✓

38. The financial reporting section lacked adequate skills and competencies to apply the principles of the Statements of GRAP and was inadequately capacitated. The organisational structure does not support and promote a proper system of recording, monitoring and supervision of controls to ensure that the information disclosed in the financial statements are accurate and complete as material adjustments relating to various components had to be effected after submission of the financial statements for auditing.

39. Deficiencies in the design and implementation of internal controls resulted in the municipality not conducting regular risk assessments and implementing a fraud prevention plan. A lack of accountability on the part of officials had resulted in my prior year findings not being adequately resolved.

40. Although the audit committee and internal audit are essential elements in good governance, they were not effective during the year under review. The audit committee

did not evaluate the effectiveness of internal audit or ensure that follow up audits were conducted on a timeous basis. Furthermore, the audit committee did not meet regularly and did not ensure that the internal audit unit addressed all the requirements of section 165 of the MFMA.

### **Investigations**

41. An investigation is currently being conducted by an independent body. The investigation was initiated based on an irregular manipulation of the billing system which was fraught with errors and manipulations created by the various users of the system. An investigation into this irregularity is pending.
42. An investigation is being conducted to probe the manner in which the irregular activities were reported on the fraudulent issue of road-worthy motor vehicle certificates. Three municipal officials were found guilty of the offence and disciplinary actions are currently pending, subsequent to an investigation. Two of the three officials were required to sign an acknowledgement of debt to authorise the municipality to recover the amounts due.

## **REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS**

### **Report on performance information**

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

### **The accounting officer's responsibility for the performance information**

44. 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).

### **The Auditor-General's responsibility**

45. 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 read in conjunction with section 45 of the MSA.
46. 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.
47. 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**

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

48. The integrated development plan of the Mquma Local Municipality did not include the key performance indicators and performance targets determined in terms of its performance management system, as required by sections 26(1) and 41(1) (b) of the

MSA and regulation 12 of the Municipal Planning and Performance Management regulations, 2001.

#### **Existence and functioning of a performance audit committee**

49. The performance audit committee did not:

- meet at least twice during the financial year
- review the performance management system and make recommendations in this regard to the council of the Mquma Local Municipality
- submit an auditor's report to the municipal council on the performance management system at least twice during the financial year.

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

50. The Mquma Local Municipality did not develop and implement mechanisms, systems and processes for auditing the results of performance measurement as part of its internal audit processes, as required in terms of section 45 of the MSA.

51. The municipality's internal auditors of the Mquma Local 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.

#### **Usefulness and reliability of reported performance information**

52. The following criteria were used to assess the usefulness and reliability of the information on the municipality's performance with respect to the objectives in its integrated development plan:

- **Consistency:** Has the municipality reported on its performance with regard to its objectives, indicators and targets in its approved integrated development plan?
- **Relevance:** Is the performance information as reflected in the indicators and targets clearly linked to the predetermined objectives and mandate. Is this specific and measurable, and is the time period or deadline for delivery specified?
- **Reliability:** Can the reported performance information be traced back to the source data or documentation and is the reported performance information accurate and complete in relation to the source data or documentation?

The following audit findings relate to the above criteria:

#### **Inconsistency reported performance information**

53. The Mquma Local Municipality has not reported throughout on its performance with regard to its objectives, indicators and targets as per the approved integrated development plan.

#### **Reported performance information not relevant**

54. The municipality's annual performance report did not indicate the actual performance of the municipality against pre-determined objectives, targets and key performance indicators.



## APPRECIATION

55. The assistance rendered by the staff of the Mngquma Local Municipality during the audit is sincerely appreciated.

*Auditor-General*

East London

30 November 2009



AUDITOR - GENERAL  
SOUTH AFRICA

*Auditing to build public confidence*