

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

**REPORT ON THE FINANCIAL STATEMENTS**

**Introduction**

1. I have audited the accompanying group financial statements of Buffalo City Municipality which comprise the consolidated and separate statement of financial position as at 30 June 2009, the consolidated and separate statement of financial performance, the consolidated and separate statement of changes in net assets and the consolidated and separate 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 South African Statements of Generally Recognised Accounting Practice (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 or 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)(d) of the MFMA, 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 read with *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 about 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. An audit also includes evaluating the appropriateness of accounting policies used and the

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reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

6. 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 Buffalo City Municipality in this respect will be limited to reporting on non-compliance with this disclosure requirement.
7. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

### **Basis for qualified opinion**

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

8. Depreciated replacement costs of various assets obtained by the municipality differed significantly from reasonable expected replacement costs and resulted in an overstatement of property, plant and equipment and accumulated surplus of R461.5 million. In addition, the municipality recognised all assets for which no cost information was available during the 2008-09 financial year instead of recognising these during the 2007-08 financial year as required by GRAP 3, paragraph 19(b).
9. Inadequate, inaccurate or incomplete asset descriptions in the fixed asset register resulted in it not being possible to trace physical assets to the register or vice versa. Furthermore, properties sold during the financial year were not recorded in the asset register as disposals. Explanations could also not be provided for a difference of R1.2 billion between the value of electrical infrastructure according to a valuation by a municipal consultant and the amount disclosed in note 14 to the annual financial statements. It was in these circumstances not possible, even through alternative testing, to confirm that the asset register was complete or that assets in the asset register existed.

#### **Unspent grants**

10. Note 20 to the annual financial statements included unspent grants of R309 million. This amount included interest earned on unspent grants of R36.7 million which was allocated from accumulated surplus after year-end, even though this amount had already been recognised as revenue. As a result unspent grants of R309 million was overstated and accumulated surplus understated by R36.7 million.

#### **Depreciation**

11. The municipality corrected depreciation errors against the 2008-09 depreciation charge instead of restating depreciation for the 2007-08 financial year. As a result depreciation was understated for 2007-08 by R22 987 457 and the opening balance for accumulated surplus was overstated by the same amount.

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12. Furthermore, no additional depreciation was provided on property, plant and equipment for the 2007-08 financial year as a result of the further splitting up of assets as required by GRAP3.

#### **Investment properties**

13. According to GRAP 3, paragraph 19(b) when an accounting policy is changed, changes must be applied retrospectively to prior financial periods. No adjustments were made to include the 2007-08 balance as required by the standard. This resulted in the understatement of R197.2 million in *investment properties* as well as *accumulated surplus*.

#### **Irregular expenditure**

14. It was not possible to confirm that expenditure of R1.97 billion had occurred as a result of fair and error-free processes or that procurement had been in terms of the municipality's supply chain management policy, as supporting documentation could not be provided during the audit. I was unable to determine whether this expenditure was irregular and whether it should have been disclosed as such in the annual financial statements.

#### **Commitments**

15. Commitments totalling R182.9 million were disclosed in note 44 to the annual financial statements. In the absence of supporting information it was not possible to confirm, even through alternative procedures, the completeness and accuracy of the disclosure of commitments in the financial statements.

#### **Qualified opinion**

16. In my opinion, except for the possible effects of the matters described in the Basis for qualified opinion paragraphs, the financial statements present fairly, in all material respects, the consolidated and separate financial position of Buffalo City Municipality as at 30 June 2009 and its consolidated and separate financial performance and its consolidated and separate cash flows for the year then ended, in accordance with the GRAP reporting framework and in the manner required by the MFMA and DoRA.

#### **Emphasis of matters**

I draw attention to the following matters on which I do not express a qualified opinion:

#### **Restatement of corresponding figures**

17. As disclosed in note 46 to the financial statements, the corresponding figures for 30 June 2008 have been restated as a result of corrections made in respect of prior year findings during 2009 in the financial statements of Buffalo City Municipality at, and for the year ended, 30 June 2008.



## **Going concern**

18. Buffalo City Development Agency, a municipal entity of Buffalo City Municipality has prepared its financial statements on a going concern basis, although there are a number of indicators that its financial sustainability is under threat. These include the following:
- (a) The entity's Board of directors resigned in May 2009 and new directors have not been reappointed. Buffalo City Municipality's acting municipal manager has taken over as an interim caretaker.
  - (b) In the absence of a fully functional board the Industrial Development Corporation has not committed any grant funding for the 2009-10 financial year.
  - (c) Buffalo City Municipality's grant is only sufficient for operational expenditure
  - (d) Buffalo City Municipality's has not approved the entities budget for the 2009-10 financial year.
  - (e) Buffalo City Municipality's council has approved the reconfiguration of the entity.
  - (f) All staff appointments have been frozen by Buffalo City Municipality.
  - (g) The entity operates in a net liability position.
  - (h) A significant amount is owed to the South African Revenue Service.

## **Other matters**

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

## **Unaudited supplementary schedules**

19. The supplementary information set out on pages XX to XX 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.

## **Material underspending of the budget**

20. The capital budget for the 2008-09 financial year was underspent by an amount of R318 million (46%). The underspending of capital grants is linked to the failure to implement the municipality's supply chain management policy.

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

### **Credit card transactions of the mayor**

21. Section 11(1) of the MFMA only authorises the accounting officer, chief financial officer or a duly delegated senior official to make withdrawals against the primary bank account of the municipality. A credit card was issued to the mayor of the municipality and withdrawals totalling R43 014 were made. Such withdrawals contravene section 11(1) of the MFMA and are thus regarded as irregular expenditure and were not disclosed in note 51.

### **Governance framework**

22. The governance principles that impact the auditor's opinion on the financial statements are related to the responsibilities and practices exercised by the

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accounting officer and executive management and are reflected in the internal control deficiencies and key governance responsibilities addressed below.

### Internal control deficiencies

23. 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 qualified 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 qualified opinion	CE	RA	CA	IC	M
8	Property, plant and equipment	7		3		
10	Depreciation	7		3	1	
12	Irregular expenditure	5/7		3		
13	Investment properties	7		3	1	
14	Commitments	5/7		3		

Legend	
<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

MO

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

### Control environment

24. Management failed to establish and maintain an environment throughout the municipality supportive of internal control and conscientious management. The municipality was affected by a large number of vacancies, most notably at top management level. The municipal manager and chief financial officer's positions were vacant for the greater part of the financial year.
25. The non-submission of supply chain management documentation is a concern. Serious deficiencies existed in the archiving system. The position of general manager: supply chain management was still vacant at reporting date.

### Control activities and information and communication

26. Basic control activities for property, plant and equipment such as regular reconciliations, isolating responsibilities and checks of data integrity were found to be either ineffective or non-existent for most asset classes. Systems for the recording of assets were year-end driven and as a result did not support the implementation of monthly control activities.

### Key governance responsibilities

27. 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>			

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No.	Matter	Y	N
5.	Key officials were available throughout the audit process.	✓	
<b>Development of and compliance with risk management, effective internal control and governance practices</b>			
6.	Audit committee		
	<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 62(c)(i)/95(c)(i) of the MFMA.		✓
12.	Delegations of responsibility are in place, as set out in section 79/106 of the MFMA.		✓
<b>Follow-up of audit findings</b>			
13.	The prior year audit findings have been substantially addressed.		✓
14.	Oversight resolutions have been substantially implemented.		✓
<b>Issues relating to the reporting of performance information</b>			
15.	The information systems were appropriate to facilitate the preparation of a performance report that is accurate and complete.		✓
16.	Adequate control processes and procedures are designed and implemented to ensure the accuracy and completeness of reported performance information.		✓
17.	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 municipality against its mandate, predetermined objectives, outputs, indicators and targets (section 68/87 of the MFMA).	✓	
18.	There is a functioning performance management system and performance bonuses are only paid after proper assessment and approval by those charged with governance.		✓

28. The control environment within the municipality was not conducive to sound governance and accountability as the leadership had not ensured that the control environment received the appropriate attention. Management's attention is specifically drawn to the following key governance responsibilities which according to the above table had not been effectively addressed:

- As stipulated in paragraph 25 not all procurement information was presented for audit purposes and management also did not present a copy of the annual report prior to the issue of the audit report.
- There was a lack of monitoring over financial accounting processes. This resulted in material amendments to the financial statements to avoid qualifications. Financial accounting processes had not been assessed and adjusted to ensure that all the processes supported the information requirements of the GRAP framework. The municipality migrated to new financial accounting reporting software and implementation difficulties led to omissions of disclosure in the notes.
- A complete risk assessment to supplement a risk management strategy was not conducted for the year under review. The fraud prevention plan had also not been implemented, as the municipality failed to implement its fraud mitigation strategy owing to a lack of capacity.
- In contravention of section 166(4) of the MFMA, the audit committee only had two serving members with effect from January 2009 after commencing the financial year with four members. An annual risk assessment was not carried out. This contributed towards the failure to identify risks in respect of the GRAP implementation.
- The significant deficiencies in the design and implementation of internal control in respect of the compliance with applicable laws and regulations were attributed to a lack of adherence to implemented controls and a lack of monitoring and supervision by management.
- Management had an audit intervention plan in place to address prior year findings. The plan was, however, deficient as it did not break down tasks in sufficient detail and no clear deadlines were set for the completion of tasks. This compromised effective implementation.

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

### **Report on performance information**

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

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

30. 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**

31. 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.



32. 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.
33. 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**

##### **Lack of implementation of a performance management system**

34. The municipality did not implement a framework that described and represented how the municipality's performance management system worked with respect to planning, monitoring of and reporting on performance against targets, including determining the roles of the different role players, as required in terms of regulations 7 and 8 of the Municipal Planning and Performance Management Regulations, 2001.
35. In addition, only the fourth quarter's performance information was submitted to council for monitoring and review, which was not in compliance with the municipality's framework which required all four quarters to be submitted to council and tabled for the monitoring and review of achievement of targets per the institutional scorecard.

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

36. 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?

##### **Reported performance information not reliable**

###### **Lack of source documentation**

37. Sufficient appropriate audit evidence with regard to the reported performance information of objectives 5 and 6 could not be obtained, as the relevant source documentation could not be provided for audit purposes.

- a) Number of registered indigent households entitled to basic services that were registered and received the indigent grant – no information presented.
- b) Number of public sector (council-owned) housing stock still to be transferred to beneficiaries – no information presented.
- c) Percentage of households supplied with minimum level of solid waste management services – no information presented.
- d) Number of households with access to the minimum basic standard of sanitation provision – no information presented.
- e) Number of households with access to the minimum basic standard of water provision – no information presented.

Actual performance against performance targets could not be confirmed for the following:

- a) Number of additional indigents registered – actual reported 5 000 – verified 400.
- b) Kilometres of roads upgraded annually to surfaced standards – actual reported 27 – verified 21.
- c) Kilometres of roads surfaced and gravel maintained standards – actual reported 540 kilometres – no information provided.

#### **Incomplete reporting on all predetermined objectives, indicators and targets**

38. The actual achievements with regard to all indicators and targets specified in the 2008-09 integrated development plan were not reported on for the following:

- (a) Percentage spending on Capex.
- (b) Percentage of the budget spent on companies compliant with PPPFA.
- (c) Number of serviced sites only for housing development.
- (d) Number of top structures with serviced sites.
- (e) Number of subsidised houses built with serviced sites in terms of government housing programmes.
- (f) Number of informal settlements provided with minimum level of basic services.
- (g) Number of municipal-wide risk profiling exercises conducted.
- (h) Percentage reduction in identified risks.
- (i) Reduction in percentage of pedestrian fatalities.

#### **Other observations**

##### **Water and electricity losses**

39. In contravention of section 62(1)(a) of the MFMA, the municipality incurred water losses of R16.7 million (53%) and electricity losses of R104 million (13%). These losses are viewed as excessive in comparison with other high capacity municipalities.

## APPRECIATION

40. The assistance rendered by the staff of the group during the audit is sincerely appreciated.

*Auditor - General*

East London

15 December 2009



AUDITOR - GENERAL  
SOUTH AFRICA

*Auditing to build public confidence*