

AUDITOR'S REPORT OF THE AUDITOR-GENERAL TO THE EASTERN CAPE PROVINCIAL LEGISLATURE AND THE COUNCIL ON MBHASHE MUNICIPALITY

REPORT ON THE FINANCIAL STATEMENTS

Introduction

1. I was engaged to audit the accompanying financial statements of the Mbashe Local Municipality (the municipality), which comprise the statement of financial position as at 30 June 2010, and the statement of financial performance, statement of changes in net assets and cash flow statement for the year then ended, a summary of significant accounting policies and other explanatory information, and the accounting officer's report, as set out on pages 4 to 41.

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 Generally Recognised Accounting Practice (GRAP) and in the manner required by the Municipal Finance Management Act (MFMA). 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; and making accounting estimates that are reasonable in the circumstances.

Auditor-General's responsibility

3. As required by section 188 of the Constitution of South Africa, 1996 (Act No. 108 of 1996) and section 4 of the Public Audit Act of South Africa, 2004 (Act No. 25 of 2004) (PAA), my responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with the International Standards on Auditing and *General Notice 1570 of 2009 issued in Government Gazette 32758 of 27 November 2009*. 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

Trade and other receivables

4. The gross consumer debtors balance of R17.3 million, as disclosed in note 2 to the financial statements, does not agree with the balance of R16 million per the age analysis. The entity did not reconcile the difference of R1.4 million between the financial statements and the underlying accounting records. Consequently the accounts receivable balance is overstated by R1.4 million. I could not determine the effect on the debtors account balances or classes of transactions contained in the financial statements.
5. Furthermore, the municipality did not apply the requirements of debt impairment in accordance with *South African Statement of Generally Accepted Accounting Practice, IAS 39, Financial instruments: Recognition and measurement*. Consequently, I was unable to obtain sufficient appropriate audit evidence to satisfy myself as to the valuation and allocation of the provision for bad debts impairment amounting to R14.1 million as disclosed in note 2 to the financial statements.

Employee-related costs

6. The municipality could not provide complete employee files and other appropriate documentation in support of salary payments, and other allowances. In addition, not all employees selected for testing presented themselves for physical verification. As a result I was unable to obtain sufficient appropriate evidence relating to the occurrence and accuracy

of employee-related costs of R32.8 million disclosed in notes 17 and 18 to the financial statements. The municipality's records did not permit the application of alternate audit procedures.

7. In addition, leave taken to the value of R721 272 was not recorded in the accounting records, resulting in the leave accrual, as disclosed in note 7 to the financial statements, being overstated by R721 272 and expenditure understated by the same amount.

Property, plant and equipment

8. The municipality does not have policies and procedures in place which are aligned with the recognition requirements of GRAP 17 – *Property, Plant and Equipment*. Consequently, capital assets purchased during the year were incorrectly allocated to operating expenditure and as a result property, plant and equipment are therefore understated by R1.3 million and expenditure overstated by the same amount.

Revenue

9. I was unable to verify that all revenue earned from property rates, service charges and other revenue was accounted for in the financial statements of the municipality, or whether the revenue that was disclosed was accounted for at the correct amounts, as management was unable to provide monthly billing reports totalling R9.4 million requested for audit purposes.
10. In addition, receipts for revenue collected at Elliotdale, were not submitted for audit purposes, and therefore the possibility of fraud could not be excluded.
11. As a result of the above I was unable to obtain sufficient appropriate evidence relating to the occurrence, accuracy, classification and completeness of consumer revenue amounting to R9.9 million (2009: R6 million), as disclosed in notes 11, 12 and 16 to the financial statements.

Value added tax (VAT)

12. The municipality as a registered VAT vendor should claim input vat on all qualifying expenditure transactions. Numerous instances where input vat was either claimed incorrectly or not claimed on qualifying transactions was identified during the course of the audit. I was not able to determine the full extent of this error. Consequently, I was not able to verify the completeness, existence and valuation of the VAT balance amounting to R7.1 million as disclosed in note 8 to the financial statements
13. Management did not perform a reconciliation of expenditure per the financial statements and the input VAT claimed during the year. Our performance of this reconciliation indicated a R1.2 million possible underclaiming of input vat for the period which could not be explained by management.
14. Consequently, I was not able to verify the completeness, existence and valuation of the VAT balance amounting to R7.1 million as disclosed in note 8 to the financial statements.

Capital commitments

15. According to note 29 to the annual financial statements approved and contracted capital commitments at 30 June 2010 amounted to R42 million. However, the payments and contract information used to calculate the outstanding commitment amounts were found to be incomplete, inaccurate and to include amounts that were not yet contracted, resulting in an overstatement of R26.7 million to the amount as disclosed in the note.

Irregular expenditure

16. Section 112(1) of the MFMA requires the municipality to implement and maintain an appropriate procurement and provisioning system which is fair, equitable, transparent, competitive and cost-effective. Payments amounting to R25.4 million were either made in contravention of the supply chain management requirements or were not provided for audit purposes. The amount was not included in irregular expenditure, disclosed in note 25 to the financial statements, resulting in irregular expenditure being understated by R25.4 million. The possibility of fraud could therefore also not be excluded.

Unauthorised expenditure

17. Section 53(c)(i) of the MFMA requires that the municipality approves its annual budget before the start of the related financial year. I was not provided with evidence of this approval for the year under review, and could therefore not place reliance on the budget presented for audit purposes. Consequently, I was unable to determine the level of unauthorised expenditure that may have been incurred.

Disclaimer of opinion

18. 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 matter

19. I draw attention to the matters below. My opinion is not modified in respect of these matters:

Unaudited supplementary schedules

20. The supplementary information set out on pages 44 to 46 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.

Restatement of corresponding figures

21. As disclosed in note 24 there are material misstatements in the corresponding figures which were identified during our audit of the financial statements of the current year relating to the following:

- Investments totalling R29.5 million were reported in the prior year financial statements. Due to their liquid nature these accounts were reclassified as cash and cash equivalents and are therefore now reported in note 1 to the financial statements.
- Assets totalling R12.7 million were expensed in the previous year financial statements as operating expenditure. This capital expenditure has been reclassified as property, plant and equipment and is therefore now reported in note 4 to the financial statements.
- The government grant reserve totalling R9.7 million was transferred to accumulated surpluses as the reserve is not permitted in terms of GRAP reporting framework. This correction is disclosed in note 24 to the financial statements.

Fruitless and wasteful expenditure

22. As disclosed in note 25.2 to the financial statements, the municipality has incurred R1.846 million of fruitless and wasteful expenditure during the year under review. Management has still to investigate the circumstances of these amounts.

Material losses/ impairments

23. As disclosed in note 2 to the financial statements impairments of debtors were recognised with a value of R14.1 million during the year under review.

Additional matters

24. I draw attention to the matters below. My opinion is not modified in respect of these matters:

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

25. In terms of the PAA of South Africa and *General notice 1570 of 2009*, issued in *Government Gazette No. 32758 of 27 November 2009* I include below my findings on the report on predetermined objectives, compliance with section 45 of the Municipal Systems Act and financial management (internal control).

Predetermined objectives

26. Material findings on the report on predetermined objectives, as set out on pages xx to xx, are reported below:

Non-compliance with regulatory and reporting requirements

No mid-year budget and performance assessments

27. The accounting officer of the municipality did not by 25 January assess the performance of the municipality during the first half of the financial year, taking into account the municipality's service delivery performance during the first half of the financial year and the service delivery targets and performance indicators set in the service delivery and budget implementation plan, as required by section 72 of the MFMA.

Internal auditing of performance measurements

28. The 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.

Usefulness of information

29. The following criteria were used to assess the usefulness of the planned and reported performance:
- Consistency: Has the municipality reported on its performance with regard to its objectives, indicators and targets in its approved integrated development plan, i.e. are the objectives, indicators and targets consistent between planning and reporting documents?
 - Relevance: Is there a clear and logical link between the objectives, outcomes, outputs, indicators and performance targets?
 - Measurability: Are objectives made measurable by means of indicators and targets? Are indicators well defined and verifiable and are targets specific, measurable and time bound.

The following audit findings relate to the above criteria:

No key performance indicators

30. Sufficient appropriate key performance indicators in relation to objectives of the IDP were not provided or available from the municipality. Furthermore targets recorded in the IDP are not well defined.

Planned indicators do not compare current year versus prior year performance

31. Sufficient appropriate key performance indicators in relation to objectives of the IDP do not compare current year performance versus prior year performance.

Reliability of information

32. The following criteria were used to assess the reliability of the planned and reported performance:
- **Validity:** Has the actual reported performance occurred and does it pertain to the entity i.e. can the reported performance information be traced back to the source date or documentation.
 - **Accuracy:** Amounts, numbers and other data relating to reported actual performance has been recorded and reported appropriately.
 - **Completeness:** All actual results and events that should have been recorded have been included in the reported performance information.

The following audit finding relates to the above criteria:

No reporting against predetermined objectives, indicators and targets

33. The municipality did not prepare the annual performance report in terms of section 46 of the MSA, and section 121(3) (c) of the MFMA.

Compliance with laws and regulations

Municipal Finance Management Act (Act 56 of 2003)

Accounting officers and municipal officials have not adhered to their statutory responsibilities

34. Contrary to the requirement of section 63 of the MFMA, the municipality did not have a complete fixed asset register.
35. Contrary to the requirements of section 64 of the MFMA, the debtor's age analysis does not agree with the municipality's general ledger.
36. Contrary to the requirements of section 62 of the MFMA, the accounting officer did not prevent irregular and fruitless and wasteful expenditure.
37. The financial statements submitted for audit purposes did not comply with section 122(1) of the MFMA, as material misstatements were identified during the audit, certain of these were corrected by management and those that were not corrected are included in the basis for qualified opinion paragraphs.

Municipal Structures Act (Act 117 of 1998)

Accounting officers and municipal officials have not adhered to their statutory responsibilities

38. Contrary to the requirements of section 18 of the MSA, quarterly meetings were not held by the municipality's council.

INTERNAL CONTROL

39. I considered internal control relevant to my audit of the financial statements and the report on predetermined objectives as well as compliance with the MFMA and DORA, but not for the

purpose of expressing an opinion on the effectiveness of internal control.

40. The matters reported below are limited to the significant deficiencies regarding the basis for disclaimer of opinion paragraph, the findings on the report on predetermined objectives and the findings on compliance with laws and regulations.

- **Leadership**

Management's philosophy is positive, however, oversight responsibilities over financial reporting, compliance with laws and regulations and internal control are not properly exercised. The critical position of municipal manager remained unfilled, with the position being occupied by an acting employee.

Management do not have an effective system to monitor tasks delegated to other staff members to ensure that the tasks are completed at the required quality, thus the audit turnaround strategy, despite reducing the number of report items including cash and cash equivalents, was largely unsuccessful. Excessive reliance was also placed on service providers and there is a lack of oversight over municipal policies and procedures.

Findings on non-compliance and a lack of measurability relate to a lack of required actions to address risks relating to the achievement of adequate performance reporting

- **Financial and performance management**

The financial statements and other information to be included in the annual report are not reviewed for completeness and accuracy prior to submission for audit purposes and pertinent information is not identified in a form and time frame to support financial and performance reporting.

There was also a lack of review, reconciliation and record keeping of supporting documentation for the reporting on predetermined objectives.

Despite being able to supply more evidence for audit purposes than in the previous period, the municipality still did not have adequate systems for the recording, monitoring and reporting of commitments, property, plant and equipment and irregular expenditure.

- **Governance**

The internal audit function is not effective due to a lack of capacity within the unit. As a result the municipality lost any benefit which an effective internal audit might have added to mitigate any of the items reported above.

The municipality does not have approved audit and risk committee charters. The prevention and detection of fraud and other processes regarding fraudulent activities, have also not received the appropriate and expected attention necessary.

The municipality has not implemented a performance audit committee to govern performance related matters.

OTHER REPORTS

41. No other reports or investigations are in progress or planned.

Auditor-General

Auditor - General

East London

30 November 2010



AUDITOR - GENERAL
SOUTH AFRICA

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