

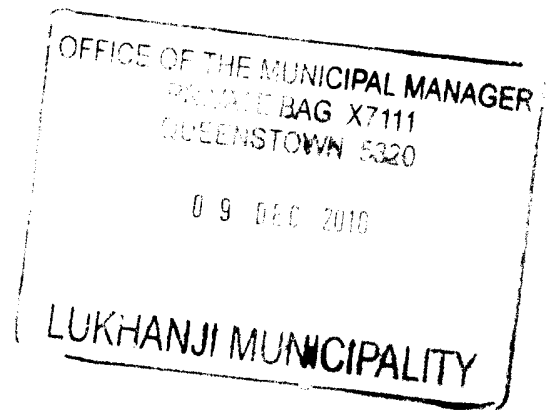


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Auditing to build public confidence

AUDITOR - GENERAL
KENYA



Lukhanji Municipality

Audit Report

for the year ended 30 June 2010

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

REPORT ON THE FINANCIAL STATEMENTS

Introduction

1. I was engaged to audit the accompanying financial statements of the Lukhanji Municipality, which comprise the statement of financial position as at 30 June 2010, and the statement of financial performance, the statement of changes in net assets and the 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 ... to

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 Municipal Finance Management Act of South Africa (Act No. 56 of 2003) (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), section 4 of the Public Audit Act of South Africa, 2004 (Act No. 25 of 2004) 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 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

Conditional grants

4. The municipality did not maintain a separate account for conditional grant funding received. At year-end the balance in the bank account totalled R106,1 million, whereas the balance for unspent conditional grants reflected in the statement of financial position totalled R36,6 million. Furthermore, grant revenue of R121,8 million was reflected in the statement of financial performance. Only R100,6 million of this amount could be traced to receipts in the bank statements of the municipality. The municipality's systems and records did not permit the application of alternative audit procedures on conditional grants. As a result, I did not obtain sufficient appropriate evidence relating to the accuracy and completeness of the grant revenue recognised in the statement of financial performance and the unspent conditional grant liability recognised in the statement of financial position.

Revenue

5. Property rates were disclosed at R33,4 million on the face of the statement of financial performance. These rates were levied based on a general valuation implemented on 1 July 2010. The municipality did not submit the valuation roll and a reconciliation of the rates revenue per the general ledger with the valuation roll for audit purposes. There were no alternative audit procedures that I could perform to obtain reasonable assurance that rates revenue was accurate and complete. Consequently, I did not obtain sufficient appropriate evidence relating to the accuracy and completeness of rates revenue as recorded in the statement of financial performance.
6. Revenue from exchange transactions was not disclosed and measured at fair value taking into account imputed interest as required by the International Financial Reporting Standard, IFRS 7 *Financial Instruments: Disclosure* and the International Accounting Standard, IAS 39 *Financial Instruments: Recognition and Measurement*. As a result, revenue from exchange transactions disclosed in the statement of financial performance at R307,5 million was overstated by R1,3 million and interest earned disclosed in the statement of financial performance at R22,4 million was understated by the same amount.

Expenditure

7. Expenditure and additions to property, plant and equipment were stated at R266 million and R17,8 million, respectively, in the financial statements. The municipality did not maintain a consecutively numbered tender register. As a result, it was not possible to determine the completeness of the record of tenders submitted for audit purposes. The municipality's systems and records did not permit the application of alternative audit procedures on this record. Consequently, I did not obtain sufficient appropriate evidence relating to the accuracy and completeness of expenditure, additions to property, plant and equipment, capital commitments and irregular expenditure.
8. Expenditure was not disclosed and measured at fair value taking into account imputed interest as required by the International Financial Reporting Standard, IFRS 7 *Financial Instruments: Disclosure* and the International Accounting Standard, IAS 39 *Financial Instruments: Recognition and Measurement*. As a result, net expenditure of employee-related costs disclosed in the statement of financial performance at R177,3 million was overstated by R1,0 million and finance costs disclosed in the statement of financial performance at R1,6 million were understated by the same amount.

Employee costs

9. The financial statements reflected an amount of R77,4 million as employee-related costs, but the trial balance reflected an amount of R82,5 million. The municipality could not provide supporting documentation for the difference of R5,1 million. The municipality's records did not permit the application of alternative audit procedures on this difference. As a result, I did not obtain sufficient appropriate evidence relating to the accuracy and completeness of employee costs.
10. Leave paid out to employees who had left the municipality during the year was calculated based on the total package paid to the affected employees and not the basic salary as required by the South African Local Government Bargaining Council agreements. This resulted in overpayments of R3,4 million to the affected employees. No entries relating to

these overpayments were recorded in the financial statements. As a result, employee costs as disclosed in the statement of financial performance were overstated whilst receivables as disclosed in the statement of financial position were understated by R3,4 million.

Trade payables

11. The municipality could not provide documentation in support of the other creditors balance of R6,4 million, which was disclosed in note 10 to the financial statements as part of trade and other payables from exchange transactions. There were no alternative audit procedures that I could perform to obtain reasonable assurance that the municipality had an obligation for all trade and other payables disclosed in the financial statements. Consequently, I was unable to obtain sufficient appropriate audit evidence relating to the accuracy and obligations of trade payables disclosed in the financial statements.
12. The municipality did not include a payable of R1,5 million owed to the Cape Joint Pension Fund at year-end in its financial statements. This liability arose as a result of its obligation to subsidise a shortfall in the fund's anticipated returns for the year ended 30 June 2009. Consequently, trade and other payables as disclosed in the statement of financial position and employee costs as disclosed in the statement of financial performance were understated by R1,5 million.

Value-added tax (VAT) receivable

13. The municipality could not provide a reconciliation of the net VAT receivable of R3,8 million reflected in the financial statements with the balance according to the South African Revenue Service's statement of account of R253 765 at 30 June 2010. Even after performing alternative procedures I could not determine the reason for the difference of R3,5 million. As a result, I was unable to obtain sufficient appropriate evidence relating to the accuracy, existence and valuation of the VAT receivable balance as disclosed in the statement of financial position.

Property, plant and equipment

14. The asset register did not reflect any disposals during the financial year, but a gain on sale of assets of R3,2 million was reflected in the statement of financial performance. The municipality could not provide documentation supporting this gain on sale of assets. As the municipality's records did not permit the application of alternative procedures relating to property, plant and equipment, I did not obtain all the information and explanations I considered necessary to satisfy myself as to the occurrence and accuracy of the gain on sale of assets as well as the completeness of disposals in the asset register.
15. Accounting policy 2.1 to the annual financial statements referred to relief relating to the subsequent measurement of property, plant and equipment in terms of Directive 4 issued by the Accounting Standards Board. The municipality provided for depreciation of R9,3 million in the statement of financial performance but it did not assess residual values, useful lives and impairment of the assets when calculating the depreciation charge for the year. The limited information in the municipality's records did not allow me to re-perform these calculations. As a result, I did not obtain sufficient appropriate evidence relating to the depreciation expense recorded in the statement of financial performance and the valuation of property, plant and equipment disclosed in the statement of financial position.

Contingent liabilities

16. GRAP 19 *Provisions, Contingent Assets and Contingent Liabilities* requires disclosure of all contingent liabilities. Litigation and claims pending against the municipality to the value of R2,5 million were not disclosed in note 45 to the financial statements. As a result, the contingent liabilities of R4 million as disclosed in note 45 in terms of GRAP 19 were understated by R2,5 million.

Receivables

17. The municipality could not provide detailed supporting documentation and calculations of the other receivable of R77,7 million included in note 3 to the financial statements, which related to the Chris Hani District Municipality. Even after performing alternative procedures, I was unable to obtain sufficient appropriate evidence relating to the existence, accuracy and valuation of the other receivable balance as recognised in the statement of financial position and detailed in note 3 to the financial statements.
18. The corresponding total for receivables from non-exchange transactions was disclosed at R40,1 million on the face of the statement of financial position and in note 3 to the annual financial statements. However, trade and other receivables from non-exchange transactions in the prior year's audited annual financial statements amounted to R42,5 million. Explanations and reconciliations of the difference of R2,4 million could not be obtained. The municipality's systems and records did not permit the application of alternative audit procedures relating to this difference in the corresponding receivables amount. Consequently, I was unable to obtain sufficient appropriate evidence relating to the accuracy of the corresponding total for receivables from non-exchange transactions.

Post-employment medical benefit obligation

19. The municipality recognised a post-employment medical benefit obligation of R48,6 million on the face of the statement of financial position and in note 44 to the financial statements. However, an actuarial valuation obtained by the municipality valued this obligation at R60,3 million. As a result, the post-employment medical benefit obligation disclosed in the statement of financial position and employee costs disclosed in the statement of financial performance were understated by R11,7 million.

Provisions

20. The municipality disclosed a provision for unused electricity of R1,6 million in note 13 to the financial statements. However, this amount was included in trade payables and not provisions on the face of the statement of financial position. Consequently, the balance for provisions reflected in the statement of financial position did not agree to note 13 by an amount of R1,6 million. In addition, the corresponding figure for unused electricity was disclosed as a provision, which affected the comparability of these balances in the statement of financial position.

Irregular expenditure

21. Irregular expenditure of R1,5 million was identified during the audit as a result of the municipality's non-adherence to its supply chain management policy. This irregular expenditure was not disclosed in note 40.3 to the financial statements. As a result, irregular expenditure was understated by R1,5 million.

Capital commitments

22. The municipality disclosed capital commitments of R37,4 million in note 42 to the financial statements. However, the records supplied in support of this amount totalled R28,7 million. The difference of R8,7 million could not be reconciled or adequately explained. The available accounting records did not permit the application of alternative procedures in order to verify this difference. Consequently, I did not obtain sufficient appropriate evidence relating to the completeness and accuracy of capital commitments.

Fruitless and wasteful expenditure

23. Interest and penalties of R288 092 were incurred due to the late payment of liabilities in terms of the Compensation for Occupational Injuries and Diseases Act. This expenditure was not disclosed as required by section 125(1)(d) of the MFMA. Fruitless and wasteful expenditure was thus understated by this amount.

Disclosure

24. The municipality incurred distribution losses of approximately 32% on electricity due to technical losses on the existing network, faulty meters, own use, billing errors and theft. These losses were not disclosed in the financial statements as required by section 125(1)(d) of the MFMA.

25. Deviations from the municipality's supply chain management policy to the value of R960 052 were not disclosed in the financial statements as required by paragraph 12(1)(d)(i) of *Government Gazette 27636 of 30 May 2005*.

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 matter

27. I draw attention to the matter below. My opinion is not modified in respect of this matter:

Material losses through criminal conduct/impairments

28. The municipality suffered financial losses of R6,7 million due to fraudulent transactions processed through the main bank account during the financial year. An amount of R4,4 million has subsequently been blocked or recovered by the banks. However, this amount has not yet been refunded to the municipality. Information in this regard was contained in note 40.4 to the financial statements. An investigation into the alleged fraud is currently underway as discussed in paragraph 47 of this report.

Additional matter

29. I draw attention to the matter below. My opinion is not modified in respect of this matter:

Unaudited supplementary schedules

30. The supplementary annexures set out on pages 40 to 49 do not form part of the financial statements and are presented as additional information. I have not audited these schedules and accordingly I do not express an opinion thereon.

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

31. In terms of the PAA and *General Notice 1570 of 2009* issued in *Government Gazette 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 of South Africa, 2000 (Act No. 32 of 2000) (MSA), and financial management (internal control).

Predetermined objectives

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

Non-compliance with regulatory and reporting requirements

Content of the integrated development plan

33. The integrated development plan of the municipality did not include the financial strategy for achieving objectives, including the plan for sourcing funding and methods of financing the various objectives and targets, as required by section 26(h) of the MSA.

Lack of adoption or implementation of a performance management system

34. The municipality did not adopt a framework that described and represented how the municipality's cycle and processes of performance planning, monitoring, measurement, review, reporting and improvement would be conducted, organised and managed, including determining the roles of the different role players, as required in terms of regulation 7 and 8 of the Municipal Planning and Performance Management Regulations, 2001.

Prior year comparisons

35. The annual performance plan did not include a comparison with the prior year's performance and measures to improve performance, as required by section 46(1)(a) and (b) of the MSA.

Usefulness of reported performance information

36. 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?

37. The following audit finding relates to the above criteria:

38. The municipality did not report throughout on its performance with regard to its targets as per the approved integrated development plan. Fifteen objectives contained in the integrated development plan were not reported in the annual performance report.

Reliability of reported performance information

39. 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 data or documentation?
- **Accuracy:** Have amounts, numbers and other data relating to reported actual performance been recorded and reported appropriately?
- **Completeness:** Have all actual results and events that should have been recorded been included in the reported performance information?

The following audit findings relate to the above criteria:

40. Review of supporting evidence revealed that the actual performance contained in the annual performance report for seven objectives was not accurately documented.

41. The municipality reported on four items in its annual performance report that were not included in its approved integrated development plan.

Compliance with laws and regulations

Municipal Finance Management Act

Expenditure was not paid within the parameters set by applicable legislation

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

The internal audit unit was not properly established or not functioning properly

43. The municipality's internal audit division did not fulfil all of its responsibilities as required by section 165(2) of the MFMA.

The audit committee was not properly established or not functioning properly

44. The audit committee did not dispense with all its duties as required by section 166(1) and (2)(a) of the MFMA.

The financial statements were not prepared in accordance with applicable legislation

45. The financial statements submitted for auditing did not comply with section 122(1) of the MFMA. Material misstatements were identified during the audit and were not corrected. These misstatements were included in the basis for disclaimer of opinion paragraphs.

The accounting officer did not adhere to his statutory responsibilities

46. The accounting officer did not take all reasonable steps to ensure that the irregular and the fruitless and wasteful expenditure incurred were prevented as required by section 62(1)(d) of the MFMA.

Compliance with other enabling legislation

47. The municipality did not submit all information, returns, documents, explanations and motivations as may be prescribed or may be required to the National Treasury as required by section 74(1) of the MFMA.

48. The municipality did not place all documentation on its official website as required by section 75 of the MFMA.

INTERNAL CONTROL

49. I considered internal control relevant to my audit of the financial statements and the report on predetermined objectives and compliance with the MFMA and the Division of Revenue Act of South Africa, 2009 (Act No. 12 of 2009) (DoRA), but not for the purpose of expressing an opinion on the effectiveness of internal control.

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

- **Leadership**

51. Management's philosophy was positive, but oversight responsibilities over reporting, compliance with laws and regulations and internal control were not exercised and the accounting officer did not evaluate whether management had implemented effective internal controls. Municipal officials did not monitor tasks delegated to other staff members. Excessive reliance was placed on certain staff. This coupled with the lack of oversight of delegated tasks resulted in the disruption to municipal processes and service delivery.

- **Financial and performance management**

52. The financial statements and other information to be included in the annual report were not reviewed for completeness and accuracy prior to submission for auditing. Pertinent information was not identified in a form and time frame to support financial and performance reporting. A working paper file was not prepared to support the financial statements in order for management to determine whether amounts and disclosures included in the financial statements were complete and accurate.

- **Governance**

53. The internal audit division was not effective in performing its duties and responsibilities as it was understaffed. The annual internal audit plan did not cover important risks to the municipality's operations, such as procurement and predetermined objectives. The plan was also not completed during the year as 13 planned audits were not conducted. These limitations affected the adequate discharge of the audit committee's duties during the year under review. Review of the minutes of audit committee meetings revealed limited interaction between the municipality and the audit committee.
54. The audit committee did not exercise sufficient oversight over the implementation of the internal audit function, as the internal audit plan was approved late in the financial year and all planned audits were not completed. Furthermore, the internal audit division did not devote sufficient attention to high risk areas of the municipality's operations. This contributed to the findings mentioned in the preceding paragraphs.

OTHER REPORTS

Investigations

Investigations in progress

55. The South African Police Service is currently conducting an investigation instigated at the request of the council into the unauthorised transfer of funds from the municipality's bank account in April 2010. The municipality placed two officials on a precautionary suspension whilst the investigation is being conducted. Subsequent to year-end, the Eastern Cape Department of Local Government and Traditional Affairs commissioned a forensic investigation into the same matter.

Auditor-General

East London

30 November 2010



**AUDITOR - GENERAL
SOUTH AFRICA**

Auditing to build public confidence