

# **Joe Gqabi District 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 OF JOE GQABI DISTRICT MUNICIPALITY**

## **REPORT ON THE CONSOLIDATED FINANCIAL STATEMENTS**

### **Introduction**

1. I have audited the accompanying consolidated financial statements and financial statements of the Joe Gqabi District Municipality, which comprise the consolidated and separate statement of financial position as at 30 June 2010, and the consolidated and separate statement of financial performance, statement of changes in net assets and cash flow statement for the year then ended and a summary of significant accounting policies and other explanatory information, as set out on pages ... to ....

### **Accounting officer's responsibility for the consolidated financial statements**

2. The accounting officer is responsible for the preparation and fair presentation of these consolidated and separate financial statements in accordance with statements of Generally Recognised Accounting Practice (GRAP) and in the manner required by the Municipal Finance Management Act of South Africa (Act no. 56 of 2003) (MFMA) and Division of Revenue Act of South Africa (Act no. 12 of 2009) (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; 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) (PAA) and section 126(3) 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 International Standards on Auditing and General Notice 1570 of 2009 issued in *Government Gazette 32758 of 27 November 2009*. 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 reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.
6. 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**

### **Trade and Other Payables**

7. Creditors statements and reconciliations were not presented for audit purposes and as a result it was not possible to carry out all of the required audit procedures or to obtain all the information and explanations considered necessary to verify the completeness of an amount of R37.9 m (2009: R8.5 m) included in Trade and Other Payables of R57.2 m (2009: R17.6 m) as disclosed in note 5 to the financial statements. As a result, I am unable to express an opinion on the completeness of Trade and Other Payables and the related Expenditure, Property, Plant and Equipment and Government Grant and Subsidy Revenue. As a result, even after performing alternative procedures, I was unable to obtain sufficient appropriate evidence relating to the completeness of trade and other payables.
8. Furthermore, included in Trade and Other Payables of R57.2 m (2009: R17.6 m) is an amount of R1.7 m (2009: R2.8 m) relating to the amount owing to Maletswai Local Municipality in terms of the agreement referred to in paragraph 9.1 below. This balance was not supported by appropriate documentation or other appropriate records. In addition there is a difference of R8.8 m between the amount confirmed by Maletswai Local Municipality and the Municipality's General Ledger. Even after performing alternative procedures at the Maletswai Local Municipality, I was unable to obtain sufficient, appropriate audit evidence relating to the obligations, completeness, classification, accuracy and cut-off of the Maletswai Local Municipality Payable. In addition, a payment of R1.2 m was erroneously processed against the VAT Receivable as opposed to this Trade and Other Payable. As a result, I am unable to conclude on the valuation and completeness of the Maletswai Local Municipality Payable of R1.7 m (2009: R2.9 m).

### **Value Added Taxation Receivable**

9. Included in the amount for the South African Revenue Services Receivable of R8.9 m (2009: R8.3 m) as disclosed in the statement of financial position is a net overstatement of R1.3 m. The overstatement includes an amount of R1.2 m that was erroneously processed against the VAT Receivable, as well as an amount of R1.7 m which was found not to exist. It was also found that the South African Revenue Services Receivable is understated by an amount of R2.1 m in respect of Trade and Other Payables that were raised exclusive of VAT. In addition, I was unable to obtain sufficient, appropriate audit evidence in support of an amount of R5.7 m included in the opening balance of the South African Revenue Services Receivable of R8.3 m as disclosed in the Statement of Financial Position.

### **Water and Sanitation Service Revenue**

10. On 1 July 2003, Joe Gqabi District Municipality assumed responsibility for the provision of water and sanitation services in its district in terms of Government Notice 852 issued in terms of section 84(3)(a) of the Municipal Structures Act, 1998 (Act No.117 of 1998). The Municipality entered into an agency agreement with the Maletswai Local Municipality. The Maletswai Local Municipality did not enter into the new service level agreement unlike the other Local Municipalities in the District Municipality's jurisdiction. The Municipality recorded Water and Sanitation Service Revenue of R10.2 m (2009: Rnil) in respect of the agency agreement with Maletswai Local Municipality. This amount is disclosed in the statement of financial performance. Even after performing alternative procedures, I was

unable to obtain sufficient, appropriate audit evidence to satisfy myself as to the completeness of such water and sanitation service revenue as no controls are in place to ensure that all water meters are linked to an account. As a result, I am unable to express an opinion on the completeness of the related Receivables from Exchange Transactions. The Municipality's accounting records did not permit the application of alternative audit procedures.

11. My audit report on the financial statements of the Municipality for the year ended 30 June 2009 was modified because it did not record service revenue for the previous financial year in respect of the water and sanitation services rendered on its behalf by the Local Municipalities. The amount of such service revenue could not be quantified. The corresponding figures in the current year financial statements have not been amended to record this revenue. As a result my opinion on the financial statements for the current year is also modified due to the comparability of this information.

### **Expenditure**

12. I was unable to satisfy myself as to the occurrence, accuracy and completeness of Water and Sanitation Charges to an amount of R6.3 m included in the amount of R13.4 m as disclosed in note 26 to the financial statements. This is a result of the fact that no support could be provided. Due to the limitations imposed, we are unable to conclude as to whether or not the related expenditure constitutes Fruitless and Wasteful or Irregular Expenditure. The Municipality's accounting records did not permit the application of alternative audit procedures. This matter is related to the matter reported in paragraph 9.1 above.
13. My audit report on the financial statements of the Municipality for the year ended 30 June 2009 was modified because it did not record service expenditure for the previous financial year in respect of the water and sanitation services rendered on its behalf by the Local Municipalities. The amount of such service expenditure could not be quantified. The corresponding figures in the current year financial statements have not been amended to record this expenditure. As a result my opinion on the financial statements for the current year is also modified due to the comparability of this information.

### **Other Receivables from Exchange Transactions**

14. No supporting documentation was obtained to support the existence and valuation of Other Receivables from Exchange Transactions estimated at an amount of R2.3 m (2009: R2 m) included in the amounts of R3.1 m (2009: R1.5 m) and R1.9 m (2009: R0.5 m) as disclosed in note 13 to the financial statements. This is a result of the fact that subsequent receipts could not be traced to supporting documentation. The Municipality's accounting records did not permit the application of alternative audit procedures. This matter is related to the matter reported in paragraph 9.1 above.
15. I was unable to obtain sufficient, appropriate audit evidence to conclude on the amount of the Doubtful Debt Provision with a value of R2 m (2009: R1.5 m) included in the R3.8 m (2009: R7.3 m) as disclosed in note 13 to the financial statements. The Municipality could not provide a sound rationale in terms of *IAS 39 - Financial Instruments: Recognition and Measurement* for the amount provided. This together with the fact that existence and valuation of Other Receivables from Exchange Transactions could not be substantiated resulted in an inability to obtain the required evidence. The Municipality's accounting

records did not permit the application of alternative audit procedures. As a result sufficient appropriate audit evidence relating to the existence and valuation of receivables could not be obtained. This matter is related to the matter reported in paragraph 9.1 above.

16. My audit report on the financial statements of the Municipality for the year ended 30 June 2009 was modified because it did not record Other Receivables from Exchange Transactions for the previous financial year in respect of the water and sanitation services rendered on its behalf by the Local Municipalities. The amount of such Other Receivables from Exchange Transactions could not be quantified. The corresponding figures in the current year financial statements have not been amended to record these Other Receivables from Exchange Transactions. As a result my opinion on the financial statements for the current year is also modified due to the comparability of this information.

### **Property, Plant and Equipment**

17. I was unable to obtain sufficient, appropriate audit evidence to conclude on the completeness of Infrastructure Assets disclosed at a net book value of R352.6 m (2009: R269.4 m) as disclosed in note 8 to the financial statements. The maximum understatement was determined at R9.9 m. This is a result of the fact that the valuation of Infrastructure Assets was performed from records that could not be reconciled to the financial system. The Municipality's accounting records did not permit the application of alternative audit procedures.

### **Employee Benefits**

18. Included in Actuarial Gains of R5.5 m disclosed in the Statement of financial performance is an amount of R3.6 m relating to a decrease in the Employee Benefit Obligation as a result of the fact that the incorrect Benefit Policy was communicated to the Actuaries in the previous financial year. As a result Actuarial Gains are overstated by this amount and the Employee Benefit obligation for Ex Gratia Gratuities stated at R 3.9 m for the previous year as disclosed in note 3 to the financial statements are overstated by a similar amount.

### **Irregular Expenditure**

19. Section 1 of the MFMA defines Irregular Expenditure as expenditure incurred by a Municipality that is not in accordance with a requirement of this act, and which has not been condoned in terms of section 170. Irregular expenditure amounting to an estimated R7.5 m (2009: R65.2 m) was identified which resulted from non-compliance with the Municipality's supply chain management policy. This Irregular Expenditure was not disclosed as required by section 125(2)(d) of the MFMA and therefore Irregular Expenditure is understated, as disclosed in note 36.3 to the financial statements.

## **Opinion**

20. In my opinion, except for the effects of the matters described in the basis for qualified opinion paragraphs, these consolidated and separate financial statements present fairly, in all material respects, the consolidated and separate financial position of the Joe Gqabi District Municipality as at 30 June 2010 and its consolidated and separate financial performance and its consolidated and separate cash flows for the year then ended, are prepared, in all material respects, in accordance with GRAP and in the manner required by the MFMA and DoRA.

## **Emphasis of matters**

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

## **Restatement of corresponding figures**

22. As disclosed in note 30 to the consolidated and separate financial statements, the corresponding figures for 30 June 2009 have been restated as a result of errors discovered during the year ended 30 June 2010 in the separate financial statements of the Joe Gqabi District Municipality at, and for the year ended, 30 June 2009. All the material restatements of corresponding figures in the current year were reported on in the audit report for the year ended 30 June 2009.

## **Unauthorised and Fruitless and Wasteful Expenditure**

23. As disclosed in note 36.1 to the consolidated and separate financial statements, Unauthorised Expenditure to the amount of R40.3 m was incurred. This expenditure was mainly incurred on Emergency Drought Relief and Water and Sanitation Service Expenditure that was not budgeted for.

24. As disclosed in note 36.2 to the consolidated and separate financial statements, Fruitless and Wasteful Expenditure to the amount of R2 m was incurred. This resulted from a write-off of Receivables from Exchange Transactions and is a direct result of the poor controls implemented over Receivables. This resulted in a financial loss to the entity.

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

25. As required by the PAA and in terms of 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 the MFMA, DoRA, Municipal Systems Act of South Africa (Act No. 32 of 2000) (MSA), Municipal Structures Act of South Africa, (Act No. 117 of 1998) 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**

27. The Joe Gqabi District 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.
28. The Joe Gqabi District Municipality did not effectively implement its performance management framework resulting in anomalies in the cycle and processes of performance planning, monitoring, measurement, review, reporting and improvement and how they are conducted, organised and managed, including correctly determining the roles of the different role players, as required in terms of section 38 of the MSA.
29. Although the accounting officer of the Joe Gqabi District Municipality assessed the performance of the Municipality, this was not done within the required timeframe (3 days late), 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.
30. I was unable to obtain sufficient appropriate audit evidence to satisfy myself that the integrated development plan was made public within 14 days of the adoption of the document.

### **Usefulness of information**

31. 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?

32. The following audit findings relate to the above criteria:

### **Reported information not consistent with planned objectives, indicators and targets**

33. The integrated development plan is not completely aligned with the annual performance report as all indicators and targets which were set in the integrated development plan were not reported on in the annual performance report.

### **Planned and reported performance targets not specific**

34. For the selected programmes, 67% of the planned and reported targets were not specific in clearly identifying the nature and the required level of performance.

### **Reliability of information**

35. The following criteria were used to assess the usefulness 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:** 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.

36. The following audit findings relate to the above criteria:

### **Reported targets not reliable when compared to source information**

37. For the selected programmes, 52% of the information on targets was not responding directly to the set targets, was not accurate nor complete on the basis of the source information or evidence provided to support the reported targets.

## **COMPLIANCE WITH LAWS AND REGULATIONS**

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

#### **The consolidated and separate financial statements were not prepared in accordance with applicable legislation**

38. The consolidated and separate financial statements submitted for audit did not comply with section 122(1) of the MFMA. The Municipality submitted consolidated and separate financial statements that were materially and pervasively misstated in order to meet the statutory deadline.
39. Material and pervasive misstatements were identified during the audit, the majority of these were corrected by management and those that were not are included in the basis for qualified opinion paragraphs.
40. Not all disclosures of non-compliance with the MFMA were made in the consolidated and separate financial statements as required by section 125 of the MFMA.

#### **Expenditure incurred was made in vain or could have been avoided resulting in fruitless and wasteful expenditure**

41. Fruitless and Wasteful expenditure was incurred on the write-off of poorly controlled Other Receivables from Exchange Transactions to the amount of R2 m in contravention of section 62(d) of the MFMA.



### **Expenditure was not paid within the parameters set by the applicable legislation**

42. All monies owing by the Municipality were not paid within 30 days of receiving the relevant invoice or statement as required in terms of section 65 (2)(e) of the MFMA. Invoices to the amount of R10.3 m were paid late.

### **The accounting officer did not adhere to his statutory responsibilities**

43. The Accounting Officer was unsuccessful in his duties to ensure that the Municipality had and maintained effective, efficient and transparent systems of financial and risk management and internal control and of internal audit operating in accordance with prescribed norms and standards throughout the year as required by section 62 (c) of the MFMA.
44. The Accounting Officer was unsuccessful in his duties to ensure that all unauthorised, irregular or fruitless and wasteful expenditure and other losses were prevented as required by section 62 (d) of the MFMA.
45. The Accounting Officer was unsuccessful in his duties to ensure that the Municipality has and maintains an effective system of expenditure control and creditors thereby ensuring that a management, accounting and information system is maintained which ensures that expenditure is recognised when it is incurred and accounts for all creditors of the Municipality as required by section 65 of the MFMA.

### **Municipal officials did not adhere to their statutory responsibilities**

46. The responsibilities referred to above were delegated to other senior managers and as a result they failed in a number of their duties to ensure compliance with section 78 of the MFMA.

### **The Audit Committee was not properly established or not functioning properly**

47. The Audit Committee did not fulfil all of its responsibilities for the year as set out in section 166(2) of the MFMA. Refer to paragraph 25.3 below for details.

### **The Internal Audit Unit was not properly established or not functioning properly**

48. The internal audit function did not fulfil all of its responsibilities for the year as set out in section 165(2) of the MFMA. Refer to paragraph 25.3 below for details.

## **INTERNAL CONTROL**

49. I considered internal control relevant to my audit of the consolidated and separate financial statements and the report on predetermined objectives as well as compliance with the MFMA, DoRA, Municipal Systems Act of South Africa (Act No. 32 of 2000), Municipal Structures Act of South Africa, (Act No. 117 of 1998), 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 qualified opinion paragraph, the findings on the report on predetermined objectives and the findings on compliance with laws and regulations.

## **Leadership**

51. The financial systems and procedures in the finance department are not adequately documented in policy and procedures manuals. As a result there is a lack of guidance on the processes and procedures to be followed when conducting the financial affairs of the entity. This lead to the numerous misstatements in the financial records, scope limitations on the audit thereof, a poor control environment and lack of control activities to ensure that errors are prevented, detected and corrected.
52. Elements of management's operating style do not promote effective control over financial reporting. There is a lack of management review and supervision of the financial affairs of the entity. Inadequate management review of journal entries, the general ledger and month end reconciliations were noted throughout the audit process. This is evident from the extent of misstatements reported and scope limitations imposed.
53. The accounting officer does not exercise sufficient oversight responsibility over reporting and compliance with laws and regulations and internal control. This is evident from the extent of misstatements reported and the instances of non-compliance reported.
54. An effective organisational structure that places people with appropriate skills is not established. Senior and middle management in finance have inadequate knowledge of accounting best practice and the accounting standards applicable to the presentation of the consolidated and separate financial statements. In addition, the job grades consistently do not correspond to the level of work being performed by senior and middle management.

## **Financial and performance management**

55. Pertinent information is not identified and captured in a form and time frame to support financial reporting. This lead to the numerous misstatements in the financial records.
56. The consolidated and separate financial statements were subject to material and pervasive amendments resulting from the audit. The Municipality submitted consolidated and separate financial statements that were materially and pervasively misstated in order to meet the statutory deadline.
57. Requested information was in some instances not available and not supplied without significant delay. This contributed to limitations of scope as referred to above.
58. Manual or automated controls are not designed to ensure that the transactions have occurred, authorised, completely and accurately processed. Basic control activities like bank reconciliations, creditors reconciliations and management review of the general ledger were either ineffective in design and implementation or did not operate effectively. Furthermore, there is a lack of sophisticated automated controls in the Municipality's IT system. For example duplicate invoices and payments will not be prevented by the system.
59. Systems are not appropriate to facilitate the preparation of financial statements that are fairly stated. Adequate financial information is often not available, not reliable and requires a large extent of manual manipulation or when available is not interpreted in a manner that will ensure that the accounting substance of transactions are accounted for in all instances.

## Governance

60. Internal controls are neither sufficient nor comprehensive enough to prevent or detect and correct material misstatements in financial reporting.
61. Internal control deficiencies are not identified and communicated timely to allow for timely corrective action, as a significant reliance is placed on consultants and the external audit process to detect material misstatements.
62. Internal audit did not fulfil all its responsibilities as set out in legislation and in accordance with accepted best practice and standards. The main concerns are that Internal Audit did not report quarterly on the Performance Management System and no follow-up audits were performed.
63. The audit committee did not fulfil all its responsibilities as set out in legislation and in accordance with accepted best practice. The audit committee did not perform the functions required by a Performance Management Audit Committee, they failed to identify numerous instances of non-compliance with GRAP. They did not enforce an evaluation of their effectiveness to be performed by Council and the Speaker and also did not evaluate key financial staff and the chairman of the audit committee did not attend meetings regularly.
64. The risk assessment process is not sufficiently effective as certain key risks were not identified, the correct level of management and staff members were not involved in the process, risks were not identified at an activity-level, risks were neither properly evaluated, nor monitored, relevant control activities were not identified and mitigating controls were not implemented.
65. Management's monitoring process is not fully effective. Management has not put a formal, comprehensive and documented plan in place to ensure that all the controls in the entity are subjected to routine monitoring internally. This is necessary to ensure a coordinated effort between management, staff and internal audit. The management team have not yet implemented any plans to monitor control activities internally.

*Auditor-General*

East London

14 December 2010



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SOUTH AFRICA

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