

# REPORT OF THE AUDITOR-GENERAL TO THE EASTERN CAPE PROVINCIAL LEGISLATURE AND THE COUNCIL ON KOUGA MUNICIPALITY

## REPORT ON THE CONSOLIDATED FINANCIAL STATEMENTS

### Introduction

1. I was engaged to audit the accompanying consolidated and separate financial statements of the Kouga Municipality, which comprise the statement of financial position as at 30 June 2011, 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 South African Standards of Generally Recognised Accounting Practice (GRAP) and the requirements of the Municipal Finance Management Act of South Africa, 2003 (Act No. 56 of 2003) (MFMA) and the Division of Revenue Act, 2010 (Act No. 1 of 2010 as amended) (DORA), as well as for such internal control as management determines necessary to enable the preparation of consolidated and separate financial statements that are free from material misstatement, whether due to fraud or error.

### Auditor-General's responsibility

3. As required by section 188 of the Constitution of the Republic 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 the consolidated and separate financial statements based on conducting the audit in accordance with the International Standards on Auditing and *General notice 1111 of 2010* issued in *Government Gazette 33872 of 15 December 2010*. Because of the matters described in the Basis for disclaimer of opinion paragraphs however, I was unable to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

### Basis for disclaimer of opinion

#### Property, Plant and equipment

4. The municipality could not provide a fixed asset register prepared in accordance with the requirements of GRAP 17, *Property, Plant and Equipment* as the process to identify, recognise and value the individual components of assets as well as evaluate the residual values and useful lives of property, plant and equipment was not completed. In addition, I was unable to verify the existence of tangible capital assets, totalling R17.8 million. There were no satisfactory alternative procedures I could perform under these circumstances. Consequently, I did not obtain sufficient appropriate audit evidence to satisfy myself as to the valuation and allocation, existence, completeness and classification of property, plant and equipment of R379.7 million (2010: R350.2 million) included in note 12 to the financial statements.
5. The municipality did not disclose a reconciliation of the carrying amount at the beginning and end of the period for property, plant and equipment, in accordance with the requirements of GRAP 17. The municipalities records did not permit the application of alternative procedures to determine the amounts to be disclosed in the reconciliation.

### **Irregular, fruitless and wasteful expenditure**

6. Section 111 of the MFMA requires that each municipality must have and implement a supply chain management policy. Payments amounting to R44.8 million were made in contravention of the supply chain management regulations. The amount was not included in irregular expenditure, disclosed in note 41 to the financial statements. Consequently irregular expenditure disclosed in note 41 to the financial statements understated by R44.8 million.
7. Section 57 (4B) of the Municipal Systems Act of South Africa, 2000 (Act No 32 of 2000) (MSA) states that performance bonuses may be awarded to a municipal manager or a manager directly accountable to the municipal manager after the end of the financial year and only after an evaluation of the performance and approval of such evaluation by the municipal council concerned. Performance bonuses paid of R389 675 included in disclosure note 31 to the financial statements were not approved by council. The amount was not included in irregular expenditure, disclosed in note 41 to the financial statements, resulting in irregular expenditure being understated by R389 675.
8. Section 60(1)(b) of the MSA requires that the alteration of the remuneration, benefits or other conditions of service of the municipal manager or managers directly responsible to the municipal manager may within a policy framework determined by the municipal council be delegated to an executive committee or executive mayor only. Payments were made to directors totalling R1.6 million that were not approved by the delegations as required by section 60(1)(b) of the MSA. The irregular expenditure was incorrectly included in fruitless and wasteful expenditure disclosure in note 41 to the financial statements. Consequently, irregular expenditure is understated and fruitless and wasteful expenditure overstated by R1.6 million.
9. Payments which could have been avoided amounting to R1.1 million in respect of compensation of employees were incurred as due care was not taken by officials on calculation of acting allowance paid to managers. The fruitless and wasteful expenditure was incorrectly included in irregular expenditure as disclosed in note 41 to the financial statements. Consequently, fruitless and wasteful expenditure is understated and irregular expenditure overstated by R1.1 million.
10. I was unable to obtain sufficient supporting documentation for fruitless and wasteful expenditure that was condoned to the value of R21.4 million, this figure was deducted to arrive at the comparative figure of R5.3 million disclosed in note 40 to the financial statements. The municipality's records did not permit the application of alternative audit procedures. Consequently, I did not obtain all the information and explanations I considered necessary to satisfy myself as to the completeness and valuation and allocation of fruitless and wasteful expenditure.

### **Creditors**

11. Creditors are disclosed at R107 million in the statement of financial position and note 8 to the financial statements. The municipality did not maintain adequate records of outstanding payments for goods and services received but not yet paid. I could not obtain sufficient appropriate audit evidence supporting creditors and accruals to the value of R25.3 million included in note 8 to the financial statements. In addition the municipality could not provide sufficient appropriate audit evidence to support a journal entry decreasing creditors by R13 million. The municipality's records did not permit the application of alternative procedures regarding these creditors and accrual balances. Consequently, I did not obtain all the information and explanations I considered necessary to satisfy myself as to the existence, obligations and completeness of these creditors and accruals.
12. Included in the creditor's balance of R107 million as disclosed in note 8 to the financial statements is an amount relating to consumer debtors with credit balances to the value of R6.6 million due to advance payments received from these debtors, however these debtors have not been billed for services rendered. Consequently, revenue is understated and creditors overstated by R6.6 million.
13. Outstanding payroll creditor payments of R8.9 million, included as reconciling items on the bank reconciliation were not accrued for as creditors. Had the accrual been provided for, cash and cash equivalent would have been stated at R4.3 million and creditors at R115.9 million. Consequently, cash and cash equivalents and creditors are understated by R8.9 million.
14. The International Accounting Standard 39, (IAS 39) *Financial instruments: Recognition and measurement* states that an entity shall measure financial assets at their fair values, loans and receivables shall be measured at amortised cost using the effective interest rate method. The municipality did not measure creditors at fair value as required by IAS 39. Consequently creditors as disclosed in note 8 to the financial statements are overstated by R4.9 million and finance income is understated by the same amount which is the effect of discounting creditors using the effective interest rate method.

### **Provisions**

15. I was unable to obtain sufficient appropriate audit evidence to confirm the long service award provision of R6.1 million included in provisions of R31.7 million as disclosed in note 5 and 7 to the financial statements. In addition the municipality could not provide approved leave forms for annual leave taken by employees to the value of R3.1 million. The municipality's records did not permit the application of alternative audit procedures. Consequently, I did not obtain all the information and explanations I considered necessary to satisfy myself of the valuation, obligation and completeness of provisions.

### **Contingent liabilities**

16. The municipality did not disclose contingent liabilities arising from litigation claims against the municipality to the value of R4.2 million. Consequently, contingent liabilities disclosed in notes 44 to the financial statements is understated by R4.2 million.

### **Finance Leases**

17. The municipality imposed a limitation on the scope of my work, as they were unable to provide me with amortisation schedules to support that the lease liability were valued in accordance with GRAP 13, Leases. In addition, the municipality could not provide sufficient appropriate audit evidence to support a journal entry decreasing the finance lease liability

and increasing accumulated surplus by R4.2 million. The municipality's records did not permit the application of alternative audit procedures. Consequently, I was unable to confirm and verify by alternative means the valuation and allocation of the finance lease liability totaling R22.9 million disclosed in note 3 to the financial statements.

### **Receivables**

18. The consumer debtors balance of R95.7 million as disclosed in note 19 to the financial statements, does not agree to the consumer debtors' age analysis balance at year end of R100.3 million. The municipality did not reconcile the difference of R4.6 million between the financial statements and the underlying accounting records. Consequently, I did not obtain sufficient appropriate audit evidence to satisfy myself as to the completeness of consumer debtors of R4.6 million. I could not determine the effect on the other account balances or classes of transactions contained in the financial statements.
19. Trade receivables from non-exchange transactions of R28.7 million and creditors of R107 million are disclosed in disclosure notes 20 and 8, respectively, to the financial statements. Included in these amounts is a journal of R13.2 million, relating to annuity loans. The journal was incorrectly processed to these accounts and was not corrected by the municipality. Consequently, trade receivables from non-exchange transactions and creditors are overstated by R13.2 million.

### **Revenue**

20. Grant revenue of R60.5 million as disclosed in note 29 to the financial statements does not agree with grant revenue of R73 million in the grant revenue reconciliation. Consequently grant revenue is understated by R12.5 million. I could not determine the effect on the other account balances or classes of transactions contained in the financial statements.
21. The property rates revenue recalculated using the valuation roll totalling R97.7 million did not agree with the total value of property rates revenue totalling R89.8 million, as disclosed in note 24 of the annual financial statements. Consequently, revenue and trade receivables from non-exchange transactions are understated by R7.9 million.
22. I was unable to obtain sufficient appropriate audit evidence to confirm rates revenue of R3.3 million included the amount of R89.8 million as disclosed in note 24 to the financial statements. The municipality's records did not permit the application of alternative audit procedures. Consequently, I did not obtain all the information and explanations I considered necessary to satisfy myself of the occurrence, completeness and accuracy of rates revenue.
23. I was unable to obtain sufficient supporting documentation to confirm prepaid electricity revenue of R5.3 million included in the amount of electricity sales of as disclosed in note 25 to the annual financial statements. The municipality's records did not permit the application of alternative audit procedures. Consequently, I did not obtain all the information and explanations I considered necessary to satisfy myself of the occurrence, completeness and accuracy of prepaid electricity revenue.

### **Employee Cost**

24. Employee cost per the statement of financial performance of R185.6 million could not be reconciled to the salary reports of R178.8 million for the year. Consequently, employee cost is understated by R6.9 million. I could not determine the effect on the other account balances or classes of transactions contained in the financial statements.

### **Long term liabilities**

25. I was unable to obtain sufficient supporting documentation to confirm that the current portion of the annuity loans of R6.8 million, as indicated in note 3 to the financial statements, was disclosed at the correct amount. The municipality's records did not permit the application of alternative audit procedures. Consequently, I did not obtain all the information and explanations I considered necessary to satisfy myself as to the valuation and allocation of annuity loans.
26. The municipality did not recognise finance cost on annuity loans amounting to R5.5 million. Had the finance cost been recognised, the effect would have been to increase interest paid to R15 million and increase long-term liabilities (current portion) to R12.3 million. Consequently interest paid and long-term liabilities disclosed in notes 35 and 3 to the financial statements respectively, are understated by R5.5 million.

### **Value added tax (VAT)**

27. The municipality was unable to reconcile VAT receivable of R4.4 million as disclosed in note 10 of the annual financial statements to the vat returns submitted to the South African Revenue Services (SARS) amounting to R49,681, resulting in an unexplained difference of R4.5 million. Consequently, I was not able to verify the rights, completeness and valuation of VAT receivable disclosed in note 10 to the financial statements.

### **Accumulated surplus**

28. The municipality could not provide sufficient appropriate audit evidence to support a journal entry decreasing accumulated surplus by R5.9 million. There were no satisfactory alternative audit procedures that I could perform to obtain reasonable assurance that accumulated surplus is properly recorded. Consequently, I did not obtain sufficient appropriate audit evidence to satisfy myself as to the existence and valuation of accumulated surplus. I could not determine the effect on the other account balances or classes of transactions contained in the financial statements.
29. The municipality could not provide sufficient appropriate audit evidence to support a journal entry increasing provisions and decreasing accumulated surplus by R3.8 million and a journal decreasing unspent conditional grants and increasing accumulated surplus by R13.4 million. There were no satisfactory alternative audit procedures that I could perform to obtain reasonable assurance that provisions, unspent conditional grants and accumulated surplus were properly recorded. Consequently, I did not obtain sufficient appropriate audit evidence to satisfy myself as to the completeness, existence, valuation and allocation of provisions, unspent conditional grants and accumulated surplus.
30. I was unable to obtain sufficient supporting documentation for expenditure incurred in the prior financial period of R15.7 million. This amount is included in the comparative figure of accumulated surplus of R154.3 million as disclosed in the statement of changes in net assets. Consequently, I did not obtain all the information and explanations I considered necessary to satisfy myself as to the existence, valuation and allocation and completeness of accumulated surplus.

### **Distribution losses**

31. Section 125(2)(d)(i) of the MFMA states that the notes to the financial statements of a municipality must disclose particulars of any material losses. Electricity losses amounting to R66.6 million were disclosed in note 55 to the financial statements. I was unable to obtain sufficient appropriate audit assurance that all distribution losses were recorded at an appropriate amount. This was as a result of the municipality being unable to provide sufficient appropriate audit evidence to support the amount disclosed. I was unable to perform alternative procedures due to a lack of controls with regard to the recording of these amounts.

### **Cash flow statement**

32. Presentation of a cash flow statement, summarising the entity's operating, investing and financing activities, is required by GRAP 2, Cash flow statements. The cash and cash equivalents as at 30 June 2011 of overdraft of R26 million presented in the cash flow statement do not agree to the cash and cash equivalents of R1.1million included in the statement of financial position. The net cash and cash equivalents in the cash flow statement are understated by R27.1 million.

### **Financial Sustainability**

33. The annual financial statements have been prepared on the assumption that the municipality will continue to operate as a going concern for at least the next 12 months. The municipality is however experiencing significant financial difficulty where the current liabilities are exceeding the current assets by R45.8 million and expenditure is exceeding income by R11.3 million that has resulted in significant cash flow constraints and it is uncertain if the municipality can settle its current liabilities in the normal course of business.

### **Disclaimer of opinion**

34. 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 these consolidated and separate financial statements.

### **Emphasis of matter**

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

#### **Material impairment**

36. As disclosed in note 19 the municipality's debtors were impaired in the current year by R3 million increasing the total provision for doubtful debts to R38.8 million (2010: R35.8 million) as at 30 June 2011.

### **ADDITIONAL MATTER PARAGRAPHS**

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

#### **Unaudited supplementary schedules**

37. The supplementary annexes C to F 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

38. In accordance with the PAA and in terms of *General notice 1111 of 2010*, issued in *Government Gazette 33872 of 15 December 2010*, I include below my findings on the material non-compliance with laws and regulations applicable to the municipality.

### **Predetermined objectives**

39. I could not conduct the audit of performance against predetermined objectives as the municipality did not submit the annual performance report as required by part C of *General notice 1111 of 2010*, issued in *Government Gazette No. 33872 of 15 December 2010*.

### **Compliance with laws and regulations**

#### **Budgets**

40. The mayor did not submit all quarterly reports to council on the implementation of the budget and the financial state of affairs of the municipality within 30 days after the end of each quarter, as required by section 52(d) of the MFMA.

#### **Financial statements, performance and annual report**

41. The financial statements submitted for auditing were not prepared in all material respects in accordance with the requirements of section 122 of the MFMA. Material misstatements identified by the auditors were not adequately corrected, which resulted in the financial statements receiving a disclaimer audit opinion.
42. The municipality did not prepare consolidated annual financial statements incorporating the annual financial statements of the municipality and of all municipal entities under the municipality's sole or effective control as required by section 122(2) of the MFMA.
43. The accounting officer did not submit the consolidated annual financial statements for auditing, within three months after the end of the financial year as required by section 126(1)(b) of the MFMA.
44. Non submission of the consolidated annual financial statements to the Auditor-General for auditing was not appropriately addressed by the Mayor and/or municipal council as per the requirements of section 133(1) of the MFMA.
45. The accounting officer did not make the 2009/2010 annual report public immediately after the annual report was tabled in the council as required by section 127(5) of the MFMA.
46. The municipal council did not adopt an oversight report containing the council's comments on the annual report within two months from the date on which the 2009/2010 annual report was tabled in the council as required by section 129(1) of the MFMA.
47. The accounting officer did not make public the council's oversight report on the 2009/2010 annual report within seven days of its adoption, as required by section 129(3) of the MFMA.
48. The performance report for the financial year under review was not prepared as required by section 46 of the MSA and section 121(3)(c) of the MFMA.

### **Audit Committee**

49. The municipality did not appoint and budget for a performance audit committee, nor was another audit committee utilised as the performance audit committee as required by Municipal Planning and Performance Management Regulation 14.

### **Internal audit**

50. The municipality did not have an internal audit unit in place as required by section 165(1) of the MFMA.

### **Procurement and contract management**

51. Goods and services with a transaction value of between R10 000 and R200 000 were procured without obtaining written price quotations from at least three different prospective providers as per the requirements of SCM regulation 17(a) & (c).
52. Goods and services of a transaction value above R200 000 were not procured without inviting competitive bids as per the requirements of SCM regulation 19(a) and 36(1).
53. The preference point system was not applied in all procurement of goods and services above R30 000 as required by section 2(a) of the Preferential Procurement Policy Framework Act and SCM regulation 28(1)(a).
54. Awards were made to suppliers based on preference points that were not allocated and/or calculated in accordance with the requirements of the Preferential Procurement Policy Framework Act and its regulations.
55. Awards were made to suppliers that did not score the highest points in the evaluation process as per the requirements of section 2(1)(f) of Preferential Procurement Policy Framework Act.
56. The performance of contractors or providers was not monitored on a monthly basis as required by section 116(2)(b) of the MFMA.
57. The contract performance measures and methods whereby they are monitored were insufficient to ensure effective contract management as per the requirements of section 116(2)(c) of the MFMA.
58. Awards were made to providers whose tax matters had not been declared by the South African Revenue Services to be in order as required by SCM regulation 43.

### **Human resource management**

59. Senior managers directly accountable to the municipal manager did not sign annual performance agreements for the year under review, as required by sections 57(1)(b) and 57(2)(a) of the MSA.
60. The municipal manager did not provide job description's for each post in the staff establishment as required by section 66(1)(b) of the MSA.

### **Expenditure management**

61. Money owing by the municipality was not always paid within 30 days of receiving an invoice or statement, as required by section 65(2)(e) of the MFMA.
62. The accounting officer did not take reasonable steps to prevent irregular expenditure and fruitless and wasteful expenditure, as required by section 62(1)(d) of the , MFMA.
63. The municipality did not recover unauthorised, irregular or fruitless and wasteful expenditure from the liable person, as required by section 32(2) of the MFMA.



### **Revenue management**

64. Revenue received by the municipality was not always reconciled at least on a weekly basis, as required by section 64(2)(h) of the MFMA.
65. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained a management, accounting and information system which recognised revenue when it is earned, as required by section 64(2)(e) of the MFMA.

### **Asset management**

66. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained a management, accounting and information system which accounts for the assets of the municipality as required by section 63(2)(a) of the MFMA.
67. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained an effective system of internal control for assets (including an asset register) as required by section 63(2)(c) of the MFMA.

### **INTERNAL CONTROL**

68. In accordance with the PAA and in terms of General notice *1111 of 2010*, issued in *Government Gazette 33872 of 15 December 2010*, I considered internal control relevant to my audit, but not for the purpose of expressing an opinion on the effectiveness of internal control. The matters reported below are limited to the significant deficiencies that resulted in the basis for disclaimer of opinion, the findings on the annual performance report and the findings on compliance with laws and regulations included in this report.

### **Leadership**

69. Effective leadership based on a culture of honesty, ethical business practices and good governance, protecting and enhancing the best interest of the municipality is not demonstrated by top management. During the year under review the chief financial officer was suspended and investigated for possible irregular payments.
70. There is a lack in oversight responsibility regarding financial and performance reporting and compliance and related internal controls. Management does not adhere to submissions of performance reports against predetermined objectives, the implementation of budgets, and is not demonstrating how the adverse current financial position will be reversed.
71. Management was not able to implement effective human resource management to ensure that adequate and sufficient skilled resources are in place and that performance is monitored. There is no approved human resource plan in place and a large number of key vacancies exist. Key positions are staffed with acting appointments, and there are weak controls over appointments, suspensions and management of vacancies.
72. The municipality does not have adequate documented policies and procedures in place to support understanding and execution of internal controls objectives, processes and responsibilities. There are no effective policies for significant business processes which resulted in non-compliance with laws and regulations and material misstatements in the financial statements.
73. No formal IT governance framework that supports and enables the business is in place to ensure value and improve performance.

## **Financial and performance management**

74. The municipality does not have proper record keeping and record management, resulting in documents supporting the amounts in the financial statements not being properly filed and easily retrievable. There were numerous delays by the municipality in providing the requested information for audit purposes.
75. The implementation of controls over daily and monthly processing and reconciliations of transactions are not effective and results in inaccurate financial reporting. Suspense accounts and accruals are not reconciled, suppliers are not reconciled to statements, commitment registers are not maintained, fixed asset registers are not reconciled to the ledger and VAT reconciliations are not performed.
76. Controls around the preparation of regular, accurate and complete financial and performance reports, supported by reliable evidence, is weak. Numerous accounts could not be explained or reconciled, and there is a lack of knowledge around the financial reporting framework that has led to non compliance to the accounting standards and the fair presentation of the financial statements, and in non compliance with laws, rules and regulations.
77. The review and monitoring of compliance with laws and regulations is not effective as there are numerous non compliance issues taking place in the areas; financial statement, performance and annual reports, procurement and contract management, expenditure management, revenue management, and asset management.
78. The design and implementation of formal controls over IT systems to ensure the reliability of the system and the availability, accuracy and protection of information needs constant improvement. There are control weaknesses mainly on lack of disaster recovery plans, security management, user access controls and environmental controls.

## **Governance**

79. The municipality did not implement appropriate risk management activities to ensure regular risk assessments, including IT risks and fraud prevention, were conducted and that the risk strategy to address these risk are developed and monitored. No risk assessment was performed during the year and no fraud prevention plan was in place for the financial year under review. The lack of these actions exposes the municipality to increased fraudulent activities.
80. The municipality is not ensuring that there is an adequately resourced and functioning internal audit unit to identify control deficiencies and recommend corrective actions effectively. The function is outsourced, and no risk assessment was conducted in the current year.
81. The activities of the audit Committee, to promote accountability and service delivery through evaluating and monitoring responses to risk, and provide oversight over the effectiveness of internal controls was limited, as they did not meet 4 times during the year, they did not receive sufficient reports from internal audit to assess risks and the responses to it, and they did not review the annual financial statements prior to submission for the external audit.

## **OTHER REPORTS**

### **Investigations**

82. Investigations were conducted by an independent consulting firm on request of council. The investigations were in respect of overpayments of acting allowances to managers and irregular payments made to directors. Both cases were finalised in the current financial year. The official responsible for the financial misconduct has been suspended.

East London

14 December 2011



**A U D I T O R - G E N E R A L**  
**S O U T H A F R I C A**

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