

**REPORT OF THE AUDITOR-GENERAL TO THE EASTERN CAPE PROVINCIAL
LEGISLATURE AND THE COUNCIL ON THE NKONKOBÉ LOCAL MUNICIPALITY**
REPORT ON THE CONSOLIDATED FINANCIAL STATEMENTS

Introduction

1. I have audited the accompanying consolidated and separate financial statements of the Nkonkobe Local Municipality, which comprise the consolidated and separate 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, a summary of significant accounting policies and other explanatory information, as set out on pages xx to xx.

Accounting officer's responsibility for the consolidated and separate 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 (SA Standards of GRAP) and the requirements of the Municipal Finance Management Act of South Africa, 2003 (Act No. 56 of 2003) (MFMA), and 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 these consolidated and separate financial statements based on my audit.
4. I conducted my audit in accordance with International Standards on Auditing and General Notice 1111 of 2010 issued in Government Gazette 33872 of 15 December 2010. Those standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated and separate financial statements are free from material misstatement.
5. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated and separate financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the consolidated and separate 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 consolidated and separate 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 consolidated and separate financial statements.
6. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my qualified audit opinion.

Basis for qualified opinion

Comparative Figures

7. In my previous audit report dated 30 November 2010, I was unable to express an audit opinion on the financial statements of the municipality for the year ended 30 June 2010. The disclaimer matters have not been adequately resolved and my audit report is modified regarding the affected corresponding figures. The entity's records did not permit the application of alternative audit procedures regarding these account balances. Consequently, I did not obtain all the information and explanations I considered necessary to satisfy myself as to the valuation of the affected account balances.

The affected account balances are:

- Cash and cash equivalents
- Trade and other receivables from exchange transactions
- VAT receivable
- Other receivables
- Trade and other payables
- Property, plant and equipment
- Unspent conditional grants and receipts
- Other loans
- Suspense accounts
- Accumulated surplus

Prior Period Error - Cash and cash equivalents

8. Adequate supporting documentation was not available to substantiate a journal amount of R23 968 524 in respect of cash and cash equivalents, and I was unable to obtain sufficient appropriate audit evidence to satisfy myself to the existence, rights, completeness and valuation of this amount.

Receivables

9. Adequate supporting documentation was not available to substantiate the amount of R5 546 124 in respect of other receivables: Indigent correction suspense. The entity's records did not permit the application of alternative audit procedures. Consequently, I was unable to obtain sufficient appropriate audit evidence to satisfy myself to the existence, rights, completeness, valuation and allocation of these receivables.

10. Adequate supporting documentation was not available to substantiate journals amounting to R4 828 001 in respect of VAT Receivable. The entity's records did not permit the application of alternative audit procedures and I was unable to obtain sufficient appropriate audit evidence to satisfy myself to the existence, rights, completeness, valuation and allocation of these receivables.

Adequate supporting documentation was not available to substantiate the amount of R1 193 131 in respect of other receivables: under and over banking. The entity's records did not permit the application of alternative audit procedures and I was unable to obtain sufficient appropriate audit evidence to satisfy myself to the existence, rights, completeness, valuation and allocation of these receivables.**Provisions**

11. Adequate supporting documentation was not available to substantiate the amount of R1 303 768 in respect of Provisions for Long Service Awards. The entity's records did not permit the application of alternative audit procedures and I was unable to obtain sufficient

appropriate audit evidence to satisfy myself to the existence, rights, completeness and valuation of this provision.

Qualified Opinion

12. In my opinion, except for the effects of the matters described in the Basis for qualified opinion paragraph, the consolidated and separate financial statements present fairly, in all material respects, the financial position of the Nkonkobe Local Municipality and its subsidiary as at 30 June 2011 and their financial performance and cash flows for the year then ended, in accordance with the SA Standards of GRAP and the MFMA.

Emphasis of matters

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

Restatement of corresponding figures

14. As disclosed in note 40 to the consolidated and separate financial statements, the corresponding figures for 30 June 2010 have been restated as a result of an error discovered during 2010/2011 in the consolidated and separate financial statements for the year ended 30 June 2010.

Unauthorised expenditure

15. As disclosed in note 30.1 to the consolidated and separate financial statements, an amount of R14 778 699 relating to unauthorised expenditure was incurred during 2010/2011 due to overspending of the budget.

Irregular expenditure

16. As disclosed in note 30.3 to the consolidated and separate financial statements, an amount of R5 129 471 relating to irregular expenditure was incurred during 2010/2011 due to non-compliance with the Municipal Supply Chain Regulations GNR 868 of 30 May 2005.

Material under spending of the conditional grant

17. As disclosed in note 9.1 to the consolidated and separate financial statements, the municipality and the municipal entity have materially under spent the conditional grants by R3 202 275. As a consequence, the entities have not fully achieved all its objectives regarding the purpose for which the grants were received.

Material losses and impairment

18. As disclosed in note 2 and note 3 to the consolidated and separate financial statements, the municipality has written off unrecoverable debts for the amount of R113 191 956 and impaired doubtful debtors for the amount of R18 866 779.

19. As disclosed in note 24 to the consolidated and separate financial statements, the municipality purchased electricity at a cost of R18 163 361. As disclosed in note 14 to the consolidated and separate financial statements, the municipality sold this electricity for R9 231 427. The municipality has incurred distribution losses amounting to R8 931 934 mainly caused by tampering and illegal connections.

Exemptions from reporting framework

20. As disclosed in accounting policy note 2.6 to the consolidated and separate financial statements, the municipality has taken advantage of Directive 4 which allows for deviations from GRAP 17 in accounting for property, plant and equipment.

Additional matter

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

Unaudited supplementary schedules

22. The supplementary information set out on pages xx to xx does not form part of the consolidated and separate financial statements and is 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

23. 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 annual performance report as set out on pages xx to xx and material non-compliance with laws and regulations applicable to the local municipality.

Predetermined objectives

Included below are the findings raised during our audit of the report on predetermined objectives:

Presentation of information

24. The following criteria are relevant to the findings below:

- Performance against predetermined objectives is reported using the National Treasury guidelines

25. Audit findings:

- **Measures taken to improve performance were not explained in the annual performance report.**

All of the indicators and targets did not have measures taken to improve performance reflected in the annual performance report as required by section 46(1)(c) of the Municipal Systems Act, 2000 (Act No. 32 of 2000) (MSA).

- **No reporting against predetermined objectives, indicators and targets – municipal entity**

26. Nkonkobe Economic Development Agency did not prepare and include an assessment by the entity's accounting officer of the entity's performance against any measurable performance objectives set, in terms of the service delivery agreement or other agreement between the entity and its parent municipality, as required by section 121(4)(d) of the MFMA.

27. In addition a service level agreement does not exist between NEDA and the parent municipality.

Usefulness of information

28. The following criteria are relevant to the findings below:

- **Consistency:** Objectives, indicators and targets are consistent between planning and reporting documents.
- **Relevance:** A clear and logical link exists between the objectives, outcomes, outputs, indicators and performance targets.
- **Measurability:** Indicators are well-defined and verifiable, and targets are specific, measurable and time-bound.

29. Audit findings:

- **Reported performance indicators were not consistent or not complete when compared with planned indicators.**

Twenty-one percent of the total number of performance indicators included in the annual performance report were not consistent with the planned indicators.

- **Reported performance targets were not consistent or not complete when compared with planned targets.**

Fifty-four percent of the total number of performance targets included in the annual performance report were not consistent with the planned targets.

- **Planned development objectives were changed but not adequately explained in the annual performance report.**

For the selected programmes, all of the development priorities/objectives that were changed were not adequately explained in the annual performance report.

- **Planned and reported performance indicators are not well defined.**

For the selected programmes, 77% of the selected indicators for testing were not clear and well defined.

- **Planned and reported performance indicators are not verifiable.**

For the selected objectives, valid performance management processes and systems that produce actual performance against the planned performance indicators do not exist for 48% of the indicators.

- **Planned and reported performance targets are not specific.**

For the selected programmes, 52% of the planned and reported targets tested were not specific.

- **Planned and reported performance targets are not measurable.**

For the selected programmes, 57% of the targets tested were not measurable.

- **Planned and reported performance targets are not time bound.**

For the selected programmes, all of the targets tested were not time bound.

Compliance with laws and regulations

30. Included below are findings on material non-compliance with laws and regulations applicable to the municipality:

Audit Committee

31. The municipality did not appoint and budget for a performance audit committee, nor was the audit committee utilised as the performance audit committee as required by regulation 14(2)(a) of the Municipal Planning and Performance Management Regulations, 2001.

Material misstatements corrected

32. The consolidated and separate financial statements submitted for auditing were not prepared in all material respects in accordance with the requirements of section 122 of the Municipal Finance Management Act. Material misstatements of liabilities, revenue, expenditure and disclosure items identified by the auditors were subsequently corrected, but the uncorrected misstatements resulted in the consolidated and separate financial statements receiving a qualified audit opinion.

Internal audit

33. The internal audit unit did not function as required by:

- Section 165(2)(b) of the MFMA in that it did not report to the audit committee on matters relating to compliance with the Municipal Finance Management Act, the Division of Revenue Act and other applicable legislation;
- Section 45(1)(a) of the MSA and Municipal Planning and Performance Management Regulation 14(1)(a) (GRN 796 of 24 August 2001) in that 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.
- Municipal Planning and Performance Management Regulation 14(1)(b)(i) and (ii) (GRN 796 of 24 August 2001) in that the internal audit processes and procedures did not include assessments of the functionality of the municipality's performance management system and whether the system complied with the requirements of the MSA.
- Municipal Planning and Performance Management Regulation 14(1)(b)(iii) (GRN 796 of 24 August 2001) in that the internal processes and procedures did not include assessments of the extent to which the municipality's performance measurements were reliable in measuring the performance of the municipality on key as well as general performance indicators.
- Municipal Planning and Performance Management Regulation 14(1)(c) (GRN 796 of 24 August 2001) in that the internal auditors of the municipality did not audit the performance measurements on a continuous basis and did not submit quarterly reports on their audits to the municipal manager and the audit committee.

Procurement and contract management

34. Valid reasons for deviating from obtaining written price quotations from at least three different prospective providers as per the requirements of Supply Chain Management Regulation 17(a) and (c) were obtained and approved for procuring goods and services with a transaction value of between R10 000 and R200 000. However these deviations were not reported at council/board meetings as per the requirements of Supply Chain Regulation 36(2).

35. Awards were made to suppliers who did not submit a declaration on their employment by the state or their relationship to a person employed by the state as per the requirements of Municipal Supply Chain Management Regulation 13(c).

36. Awards were made to providers who are persons in service of other state institutions in contravention of the requirements of Supply Chain Management Regulation 44.

37. No risk assessment was performed for the supply chain management system which is in contravention of the requirements of Supply Chain Management Regulation 41.

Oversight report

38. 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 2009/10 annual report was tabled in the council as required by section 129(1) of the Municipal Finance Management Act.

39. The accounting officer did not make public the council's oversight report on the 2009/10 annual report within seven days of its adoption, as required by section 129(3) of the Municipal Finance Management Act.

Predetermined objectives

40. The accounting officer of the municipality did not submit the results of the assessment on the performance of the municipality during the first half of the financial year to the mayor of the municipality, the National Treasury, and the provincial treasury as required by section 72(1)(b) of the Municipal Finance Management Act.

Chief Executive Officer post filled by acting position – municipal entity

41. Contrary to section 93J(1) of the Municipal Systems Act, the board of directors of the municipal entity has not appointed a Chief Executive Officer (CEO) of the municipal entity. This position has been vacant since September 2009, and there has been an acting CEO since that time.

Expenditure management

42. The accounting officer did not take reasonable steps to prevent unauthorised expenditure, irregular expenditure and fruitless and wasteful expenditure, as required by section 62(1)(d) of the Municipal Finance Management Act.

No monthly budget statements submitted by municipal entity

43. The accounting officer of Nkonkobe Economic Development Agency did not, within seven days after the end of each month, submit to the accounting officer of the parent municipality any statements in the prescribed format on the state of the entity's budget for the financial year up to the end of that month as required by section 87(11) of the MFMA.

Municipal entity did not prepare an annual report for 2009/2010

44. The accounting officer of Nkonkobe Economic Development Agency did not prepare an annual report for the previous financial year as required by section 121(1) of the MFMA.

Internal control

45. 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 qualified opinion, the findings on the annual performance report and the findings on compliance with laws and regulations included in this report.

Leadership

46. Leadership of the municipality have taken great strides in addressing the control deficiencies pertaining to financial reporting. This was done by implementing and monitoring action plans which have resulted in the financial record-keeping of the municipality improving.
47. The availability of management staff during the audit has also improved.
48. There is still scope for improvement in the oversight over financial reporting, reporting against predetermined objectives, compliance with laws and regulations and the formulation and implementation of an Information Technology (IT) strategy or governance framework for Nkonkobe Local Municipality. This is also seen in that there are still findings which have recurred for a number of years.
49. The oversight over the municipal entity needs to be strengthened significantly to address the issues that plague the entity.

Financial and performance management

50. The financial record-keeping of the municipality has improved in that records are now retrievable when required, however deficiencies still exist in the regular reconciliation of financial and performance records during the course of the financial year. This has been the main contributor to the material misstatements in the consolidated and separate financial statements and the errors in annual performance report which were identified during the audit.
51. The municipality has insufficient controls in place to ensure that relevant laws and regulations are complied with, including those relating to performance information. The poor controls have also resulted in irregularities occurring in the procurement processes of the municipality.
52. The planning, monitoring and reporting of performance against predetermined objectives is an area of concern. This is because there is inadequate understanding of setting performance targets and indicators that are specific and verifiable. The controls in place are insufficient to ensure that reported performance is consistent with what was planned.
53. The municipality relies heavily on computerised information systems to perform its statutory, financial management, reporting and administrative functions. The fact that manual and automated controls were not, in all instances, adequately implemented to ensure that the transactions have occurred, are authorised and are completely and accurately processed, is reason for concern. There is also reliance on one individual for the upkeep and administration of the entire IT system.

Governance

54. The municipality undertook a risk assessment process through which it identified key risks to which it is exposed. An internal audit plan was drafted to address these risks; however, this plan was not adequately implemented mainly due to its late approval and the internal audit function being under-capacitated.
55. The audit committee was also found not to be fully functional during the year with its charter being approved late. This has resulted in key control deficiencies not being identified during the year.
56. The internal audit and audit committee charters did not incorporate the municipal entity, namely Nkonkobe Economic Development Agency.

OTHER REPORTS

Investigations

57. There is an investigation still in progress regarding two councillors and an employee of the municipality. This investigation involves allegations of fraud that took place within the procurement process during June 2010.

East London

24 January 2012



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

Auditing to build public confidence