

REPORT OF THE AUDITOR-GENERAL TO THE EASTERN CAPE PROVINCIAL LEGISLATURE AND THE COUNCIL ON 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 2011, and the 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, 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 South African Standards of Generally Recognised Accounting Practice (GRAP) and the manner required by the Municipal Finance Management Act of South Africa, 2003 (Act No.56 of 2003) (MFMA) and the Division of Revenue Act of South Africa, 2010 (Act No.1 of 2010 as amended) (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.

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) 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 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. An amount of R710,7 million (2010: R698,4 million) is disclosed as property, plant and equipment in note 4 to the financial statements. This amount is understated by R183,8 million due to the assets that have not been recorded in the asset register. Furthermore, the asset register maintained by the municipality consists of assets that could not be physically verified to the value of R84,1 million. In addition, the municipality could not provide sufficient appropriate audit evidence for the amount disclosed in note 4 to the financial statements, due to amounts not being reconciled with supporting records. There were no satisfactory alternative audit procedures that could be performed in these circumstances. Consequently, I did not obtain sufficient appropriate audit evidence to satisfy myself as to the completeness, existence, rights and obligations, valuation and allocation of property, plant and equipment.

5. The financial statements did not reflect any disposals during the financial year, however, a gain on sale of assets of R9,4 million (2010: R3,3 million) was reflected in the statement of financial performance. The municipality did not provide documentation supporting the gain on sale of assets. The municipality's records did not permit the application of alternative audit procedures relating to property, plant and equipment. Consequently, 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 note 4 to the financial statements.

Investment property

6. The municipality did not provide sufficient supporting schedules for investment property disclosed as R91,3 million (2010: R91,3 million) in the statement of financial position as a detailed composition of investment property was not provided for audit purposes. The municipality's records did not permit the application of alternative audit procedures. As a result, I did not obtain sufficient appropriate audit evidence relating to the existence, completeness, rights and obligations and valuation and allocation of investment property at year end.

Inventory

7. Land used for the construction of Reconstruction and Development Houses had not been reclassified as inventory, as prescribed by GRAP 12, *Inventory*. The value of the land could not be determined due to the incompleteness of the fixed asset register. The municipality's records did not permit the application of alternative audit procedures. Consequently, I could not determine the completeness, existence, valuation and allocation of land incorrectly allocated to property, plant and equipment.

Accumulated surplus

8. Accumulated surplus at year-end totalling R925,9 million, as disclosed in the statement of financial position, could not be confirmed due to the uncorrected misstatements in the opening balance and the take-on values relating to property, plant and equipment and investment property. As the municipality's records did not permit the application of alternative audit procedures relating to the opening balance and take-on values, I did not obtain all the information and explanations I considered necessary to satisfy myself as to the completeness, occurrence, valuation and allocation of accumulated surplus.

Other receivables from exchange transactions

9. An amount of R106,1 million (R77,7 million) is disclosed as the Chris Hani Agency account, included in other receivables from exchange transactions in note 9 to the financial statements. This amount is overstated by R110,2 million as it could not be reconciled with supporting schedules. In addition, the municipality could not provide sufficient appropriate audit evidence for the amount disclosed as there were no adequate systems to record water and sanitation services provided on behalf of the district municipality. There were no satisfactory alternative audit procedures that I could perform in these circumstances. Consequently, I did not obtain sufficient appropriate audit evidence to satisfy myself as to the existence, completeness, valuation and allocation of the Chris Hani Agency account.

Value-added tax (VAT) receivable

10. The municipality could not provide a reconciliation of the net VAT receivable of R1,5 million (2010: R3,7 million) with the balance according to the South African Revenue Service's statement of account of R6,3 million at 30 June 2011. The municipality's records did not permit the application of alternative audit procedures. As a result, I was unable to obtain sufficient appropriate evidence relating to the existence, completeness and valuation of the VAT receivable as disclosed in the statement of financial position.
11. Furthermore, the municipality did not apply the VAT apportionment method as prescribed by the Value-Added Tax Act, 1991 (Act No. 89 of 1991). The municipality's records did not permit the application of alternative audit procedures. Consequently, I could not determine the effect on the accuracy and completeness of expenditure, as disclosed in the statement of financial performance.

Trade receivable from exchange transactions

12. Trade receivables from exchange transactions with a net balance of R20,3 million (2010: R31,7 million) disclosed in the statement of financial position, could not be supported with adequate documentation and schedules. In addition, the debt impairment provision of R153,5 million as disclosed in note 12 to the financial statements, has not been provided for in terms of the International Accounting Standard, IAS 39: *Financial Instruments: Recognition and Measurement*. The municipality's records did not permit the application of alternative audit procedures. Consequently, I did not obtain sufficient appropriate audit evidence relating to the existence, completeness, valuation and allocation of trade receivables.
13. The debt impairment expenditure of R57,5 million as disclosed in the statement of financial performance, was not supported by adequate documentation and schedules. The write-off of debtors was not supported by documentation and was not set off against the prior year debt impairment provision. The municipality's records did not permit the application of alternative audit procedures. Consequently, I did not obtain sufficient appropriate audit evidence relating to the occurrence and accuracy of debt impairment.

Revenue from exchange transactions

14. Service charges as disclosed in the statement of financial performance amounting to R130,5 million are understated by R78,9 million due to instances where consumers have not been charged for services or services that have not been levied per the approved tariff. Furthermore, there is an unexplained difference between the general ledger and the billing system of R2,8 million. The municipality's records did not permit the application of alternative audit procedures. As a result, I did not obtain sufficient appropriate audit evidence relating to the completeness, cut-off, accuracy and occurrence of service charges.

Revenue from non-exchange transactions

15. Property rates revenue of R39,3 million (2010: R32,7 million) as disclosed in the statement of financial performance is based on the general valuation which has not been reconciled with the general ledger by R5,8 million. Furthermore, properties have been captured onto the general ledger at incorrect values and not all land parcels have been captured in the general ledger. The municipality's records did not permit the application of alternative

audit procedures. Consequently, I did not obtain sufficient appropriate audit evidence relating to the completeness, cut-off, accuracy and occurrence of property rates revenue.

Employee-related costs

16. Employee-related costs amounting to R88,6 million (2010: R74,0 million) did not reconcile with the payroll, with an unexplained difference of R7,7 million. In addition, the municipality's records pertaining to overtime, contract work, allowances and basic salary could not be agreed to supporting documentation. The municipality's records did not permit the application of alternative audit procedures. Consequently, I did not obtain sufficient appropriate audit evidence relating to the occurrence, accuracy and completeness of employee costs.

Conditional grants

17. The municipality did not provide supporting documentation for unspent conditional grants and receipts totalling R15,5 million (2010: R36,6 million) as disclosed in the statement of financial position and government grant and subsidies revenue of R125,3 million (2010: R121,8 million) and grants and subsidies paid of R6,7 million (2010: R24,0 million), as disclosed in the statement of financial performance. The municipality did not maintain adequate records and supporting documentation for journal entries relating to conditional grant income and expenditure. Furthermore, I could not determine whether conditional grants were utilised for their intended purpose which would have resulted in unauthorised expenditure. The municipality's records did not permit the application of alternative audit procedures. Consequently, I could not determine the completeness, existence and valuation of unspent conditional grants and receipts, the completeness, occurrence and accuracy of conditional grant revenue and expenditure and the completeness of unauthorised expenditure.

Trade and other payables from exchange transactions

18. The municipality did not provide explanations and documentation in support of payments received in advance totalling R6,4 million (2010: R5,1 million), as included in note 18 to the financial statements as part of trade and other payables from exchange transactions. The municipality's records did not permit the application of alternative audit procedures. Consequently, I could not determine the completeness, existence and valuation of trade and other payables.
19. Accrued leave pay, as included in trade and other payables, disclosed in note 18 to the financial statements, have been calculated using inaccurate leave records. This resulted from poor maintenance of employee leave records and a lack of monitoring of employee leave balances. As a result, accrued leave pay has been overstated by R7,7 million while employee-related costs as disclosed in the statement of financial performance have been overstated by the same amount.

Expenditure

20. Administration income of R8,6 million as disclosed in the statement of financial performance has been classified as expenditure and could not be agreed to supporting documentation. The municipality's records did not permit the application of alternative audit procedures. Consequently, I could not confirm the occurrence and accuracy of

administration income.

Irregular expenditure

21. Section 125(2) of the MFMA requires the financial statements of the municipality to disclose material irregular expenditure that occurred during the financial year. Audited payments amounting to R6,1 million (2010: R1,5 million) were irregular as they were made in contravention of the supply chain management requirements. These amounts were not included in the irregular expenditure disclosure note 48 to the financial statements. Consequently, irregular expenditure as disclosed is understated by at least this amount, it was not, however, practicable to determine the full extent of the understatement as there was no system of control in place to identify all irregular expenditure incurred.

Disclosure

22. Revenue, expenditure, accounts receivable and accounts payable have not been 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. Due to the limitations described in the above paragraphs, I was unable to determine the extent of these misstatements. Consequently, I was unable to determine the accuracy of revenue and expenditure and the valuation of accounts receivable and account payable.

Disclaimer of opinion

23. 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 of an audit opinion. Accordingly, I do not express an opinion on the financial statements.

Emphasis of matters

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

Restatement of corresponding figures

25. Misstatements in the corresponding figures which were identified during the prior period audit of the financial statements, were corrected by management. Restatement of a number of classes of transactions and account balances took place as disclosed in note 43 to the financial statements.

Material losses

26. The municipality incurred distribution losses of approximately 31% (2010: 32%) or 61 567 685 kw-hours/units on electricity due to technical losses on the existing network, faulty meters, own use, billing errors and theft. These losses have been disclosed in note 52 to the financial statements as required by section 125(1)(d) of the MFMA.

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

27. 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 ... to ... and material non-compliance with laws and regulations applicable to the municipality.

Presentation of information

28. The following criteria is relevant to the finding below:

- Performance against predetermined objectives is reported in accordance with section 46 of the MSA.

Measures taken to improve performance were not provided in the performance report

29. Measures taken to improve performance were not provided in the performance report, as required in terms of section 46(1)(c) of the Municipal Systems Act of South Africa, 2000 (Act No. 32 of 2000) (MSA). In total 88% of the reported targets had no details of the measures taken to improve performance.

Usefulness of information

30. 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, and measurable and time bound

Reported objectives, indicators and targets are not consistent when compared with the planned objectives, indicators and targets

31. Reported performance against predetermined objectives, indicators and targets is not consistent with the approved integrated development plan. In total, 100% of the reported objectives, indicators and targets were not consistent when compared to the planned objectives, indicators and targets.

Planned indicators and targets are not relevant to the objectives of the entity

32. In more than 25% of instances the indicators and targets as per the annual performance report did not relate directly to the institution's objectives included in the five-year integrated development plan.

Planned and reported indicators are not well defined

33. For the selected objectives, 40% of the planned and reported indicators were not clear, as well defined data definitions were not available to allow for data to be collected consistently.

Planned and reported indicators are not verifiable

34. For the selected objectives, valid performance management processes and systems that record actual performance against the planned indicators do not exist for 37% of the

performance indicators.

Planned and reported targets are not specific, measurable and time bound

35. For the selected objectives:

- Forty-three per cent (43%) of the planned and reported targets were not specific in clearly identifying the nature and the required level of performance and were not measurable in identifying the required performance.
- Eighty-eight per cent (88%) of the planned and reported targets were not time bound in specifying the time period or deadline for delivery.

Reliability of information

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

- Validity: Actual reported performance has occurred and pertains to the entity
- Accuracy: Amounts, numbers, and other data relating to reported actual performance have been recorded and reported appropriately
- Completeness: All actual results and events that should have been recorded have been included in the annual performance report

The validity, accuracy, completeness of reported performance against indicators and targets could not be confirmed as no supporting source information was provided

37. For the objective relating to the facilitation of electricity backlogs, the validity, accuracy and completeness of the reported indicators and targets could not be established as relevant source documentation could not be provided.

Reasons for major variances between planned and actual reported targets were not supported by sufficient appropriate evidence

38. Sufficient appropriate evidence to support the reasons for major variances between the planned and the actual reported targets could not be obtained. The reasons provided for major variances could not be verified. In total, 88% of the reported targets with major variances were not explained.

Sufficient appropriate evidence was not submitted to support reported indicators and targets

39. Sufficient appropriate evidence in relation to the facilitation of the electricity backlog objective could not be obtained. There were no satisfactory audit procedures that I could perform to obtain the required assurance as to the validity, accuracy and completeness of the reported performance against predetermined objectives.

Compliance with laws and regulations

Strategic planning and performance management

40. The accounting officer of the municipality did not by 25 January 2011 assess the performance of the municipality during the first half of the financial year, taking into account the municipality's service delivery performance during the first half of the financial year and the service delivery targets and performance indicators set in the service delivery and

budget implementation plan as required by section 72(1)(a)(ii) of the MFMA.

41. 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 MFMA.

Budgets

42. The mayor did not submit all quarterly reports to the 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.
43. The accounting officer did not always submit the monthly budget statements to the mayor and the Eastern Cape Provincial Treasury, as required by section 71(1) of the MFMA.

Annual financial statements, performance and annual report

44. 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 of capital assets, current assets, liabilities, revenue, and disclosure items identified by the auditors were subsequently adjusted; however, the uncorrected material misstatements, together with the limitations imposed on the audit, resulted in the financial statements receiving a disclaimed audit opinion.
45. 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 MFMA.
46. The annual performance report did not contain a comparison of the performance of the municipality with development priorities, objectives and performance indicators set out in its integrated development plan as required by section 46 of the MSA.

Audit committee

47. The audit committee did not advise the municipal council, the political office-bearers, the accounting officer and the management staff of the municipality on matters relating to compliance with the MFMA the Division of Revenue Act and other applicable legislation as required by section 166(2)(a) of the MFMA.

Internal audit

48. The internal audit 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. Furthermore, the internal auditor did not audit the performance measurements on a continuous basis as required by Municipal Planning and Performance Management Regulation 14.

Procurement and contract management

49. 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 Supply Chain Management (SCM) regulation 17(a) & (c).

50. Quotations were accepted from prospective providers who are not on the list of accredited prospective providers and do not meet the listing requirements prescribed by the SCM policy in contravention of SCM regulations 16(b) and 17(b).
51. Bid specifications for procurement of goods and services through competitive bids were drafted in a biased manner that did not allow all potential suppliers to offer their goods or services as per the requirements of SCM regulation 27(2)(a).
52. Awards were made to providers based on criteria that differed from those stipulated in the original bid documents and/or were not stipulated in the original bid documents as per the requirements of SCM regulations 21(b) and 28(1).
53. Bid specifications were not always drafted by bid specification committees which were composed of one or more officials of the municipality as required by SCM regulation 27(3).
54. Bids were not always evaluated by bid evaluation committees which were composed of officials from the departments requiring the goods or services as per the requirements of SCM regulation 28(2).
55. Awards were made to providers whose tax matters had not been declared by the South African Revenue Service to be in order as required by SCM regulation 43.
56. 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 No.5 of 2000 (PPPFA) and SCM regulation 28(1)(a).
57. Awards were made to suppliers based on preference points that were not allocated and/or calculated in accordance with the requirements of the PPPFA and its regulations.
58. 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 PPPFA.
59. The performance of contractors or providers was not monitored on a monthly basis as required by section 116(2)(b) of the MFMA.
60. 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.

Human resource management

61. Senior managers directly accountable to the municipal manager did not sign annual performance agreements for the year under review, as required by section 57(1)(b) and 57(2)(a) of the MSA.

Expenditure management

62. 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.

63. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained a management, accounting and information system which accounted for creditors of the municipality as required by section 65(2)(b) of the MFMA.
64. The accounting officer did not take reasonable steps to prevent irregular expenditure as required by section 62(1)(d) of the MFMA.
65. The municipality did not recover irregular expenditure from the liable person, as required by section 32(2) of the MFMA.

Conditional grants

66. Sufficient appropriate audit evidence could not be obtained that the allocations for the municipal infrastructure grant, neighbourhood development partnership grant (indirect), expanded public works programme incentive grant, rural household infrastructure grant and the integrated national electrification grant (Eskom) were utilised for the purposes stipulated in their respective schedules or Gazetted DoRA framework, as required by section 15(1) of the DORA.
67. The municipality did not always submit monthly reports to the transferring national officer, the National Treasury and the provincial treasury on spending and financial performance in respect of the allocations received for municipal infrastructure grant, neighbourhood development partnership grant (indirect), expanded public works programme incentive grant, rural household infrastructure grant and the integrated national electrification grant (Eskom), as required by section 11(2)(b) of the DoRA and section 71(5) of the MFMA.
68. The municipality did not always submit quarterly reports to the transferring national officer on non-financial performance in respect of the allocation received for municipal infrastructure grant, neighbourhood development partnership grant (indirect), expanded public works programme incentive grant, rural household infrastructure grant and the integrated national electrification grant (Eskom), as required by section 11(2)(c) of the DoRA.

Revenue management

69. 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.
70. The council did not implement a tariff policy on the levying of fees for municipal services provided by the municipality, contrary to section 74(1) of the MSA.
71. 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, accounted for debtors and accounted for receipts of revenue, as required by section 64(2)(e) of the MFMA.

Asset management

72. 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.

73. 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 as required by section 63(2)(c) of the MFMA.

INTERNAL CONTROL

74. 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

75. There is a lack of oversight and accountability of senior management as sufficient monitoring controls are not in place to ensure the proper implementation of the overall process of planning, budgeting, implementation and reporting and adherence to internal policies and procedures at department level and for the purpose of taking corrective action. Although the audit action plan was formulated and implemented, it was not effective and properly monitored as audit findings on revenue, assets, conditional grant expenditure, current liabilities and current assets were repeated in the current financial year.
76. The municipality does not have adequate processes in place to identify and record irregular expenditure. There is a lack of monitoring by senior management which resulted in irregular expenditure identified in the year under review.

Financial and performance management

77. The municipality's manual and automated controls are not designed and implemented to ensure that the transactions have occurred, are authorised, and are completely and accurately processed. Management does not adequately manage transactions upon recording, which resulted in the findings under the Basis for disclaimer opinion paragraphs, predetermined objectives and compliance with laws and regulations.
78. The municipality did not prepare monthly financial performance reports. Furthermore, the municipality did not prepare monthly reconciliations relating to revenue, conditional grant expenditure, payroll and creditors. This has resulted in a lack of supporting documentation to explain material differences found during the audit.
79. There are inadequate processes and systems in place to ensure reporting against predetermined objectives. Documentation was not available during the audit to support actual results achieved performance report.

Governance

80. The municipality did not implement the approved and adopted fraud prevention plan and it could not be determined if a risk management plan, as required by the fraud prevention plan, was prepared, approved and implemented during the year under review. The municipality does not have a formal risk assessment process for the IT system in use at the municipality. This reduces the ability to appropriately address any significant deficiencies, thus increasing the number of material misstatements in the financial statements.

81. The internal audit unit and the audit committee were not fully functional for the entire financial year due to the audit charter and plan only being adopted on 28 January 2011. The audit committee was ineffective due to multiple resignations during the financial period.

OTHER REPORTS

Investigations

82. The Eastern Cape Department of Local Government and Traditional Affairs commissioned a forensic investigation into the unauthorised transfer of funds relating to the prior financial period and as reported in the previous financial period. The forensic report was issued, which resulted in council appointing a committee to further investigate the matter, with the assistance of the bank at which the transfer took place. The committee has formulated recommendations to the council on how to respond to the MEC. The outcome of the investigation has not yet been made public.
83. An investigation has been completed subsequent to year-end, whereby the municipality dismissed an official on grounds of inappropriate and irregular conduct, relating to tampering with the minutes of the bid evaluation committee.

Auditor-General

East London

30 November 2011



**AUDITOR GENERAL
SOUTH AFRICA**

Auditing to build public confidence