REPORT OF THE AUDITOR-GENERAL TO THE EASTERN CAPE PROVINCIAL LEGISLATURE AND THE COUNCIL ON THE MALETSWAI LOCAL MUNICIPALITY

REPORT ON THE FINANCIAL STATEMENTS

Introduction

1. I have audited the financial statements of the Maletswai Local Municipality set out on pages ... to ..., which comprise the statement of financial position as at 30 June 2013, the statement of financial performance, statement of changes in net assets and the cash flow statement for the year then ended, and the notes, comprising a summary of significant accounting policies and other explanatory information.

Accounting officer's responsibility for the financial statements

2. The accounting officer is responsible for the preparation and fair presentation of these financial statements in accordance with the 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 the Division of Revenue Act of South Africa, 2012 (Act No. 5 of 2012) (DoRA), and for such internal control as the accounting officer determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor-general's responsibility

3. My responsibility is to express an opinion on these financial statements based on my audit. I conducted my audit in accordance with the Public Audit Act of South Africa, 2004 (Act No. 25 of 2004) (PAA), *the General Notice* issued in terms thereof and International Standards on Auditing. 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.

4. 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.

5. 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

Land and buildings

6. The municipality did not comply with the measurement criteria as outlined in Directive 7.07: *The application of deemed cost on the adoption of standards of GRAP* and as a result land and buildings were recognised at incorrect values. In addition, the municipality did not have adequate systems in place to prepare an accurate and complete fixed asset register. This resulted in the duplication, misclassification, inappropriate recognition, as well as the omission of land and buildings from the municipality's underlying records. Consequently, land and buildings in note 12.1 are overstated by R8,49 million (2012: R9,27 million) and as a result infrastructure assets in

note 12.1 and the accumulated surplus in the statement of changes in net assets are understated by R888 693 (2012: R 558 050) and overstated by R7,60 million (2012: R 8.71 million), respectively.

Investment property

7. Investment property as disclosed in note 13 to the financial statements is understated by R4,66 million (2012: R2,79 million). This is due to the omission of and the inappropriate recognition of investment property which was not owned by the municipality. As a result, accumulated surplus in the statement of changes in net assets is also understated by the same amount in the current and prior year. In addition, the municipality did not have an adequate system in place for the identification and recognition of investment properties and did not include all the investment properties of the municipality in the amount disclosed in note 13 to the financial statements. Furthermore, no systems were in place to assign appropriate values to the investment properties as outlined in Directive 7.07: *The application of deemed cost on the adoption of standards of GRAP*. Due to the lack of systems in place, it was impracticable to determine the full extent of the understatement. I was unable to determine this amount by alternative means. Consequently, I was unable to determine whether any further adjustments to the investment property note were necessary.

Disclosure – Supply chain management deviations

8. The municipality did not have adequate systems to identify and disclose all supply chain management (SCM) deviations, as required by the Municipal SCM Regulations issued in *Government Gazette 27636 of 30 May 2005* (SCM Regulation), regulation 36(2). SCM deviations of R2,65 million (2012: R1,95 million) were not disclosed as a note to the financial statements.

Corresponding figures

9. During 2011-12 the municipality did not have adequate systems to identify and disclose all irregular expenditure. I identified an understatement of R2,79 million which is still included in the irregular expenditure corresponding figure, as disclosed in note 46.3 to the financial statements. My audit opinion on the financial statements for the period ended 2011-12 was modified accordingly. My opinion on the current period's financial statements is also modified because of the possible effect of the matter on the comparability of the current period's figures.

Aggregation of immaterial uncorrected misstatements

10. The financial statements as a whole are materially misstated due to the cumulative effect of numerous individually immaterial uncorrected misstatements in the following elements making up the statement of financial performance and the statement of financial position:

    - Total revenue reflected as R118,31 million in the statement of financial performance is understated by R477 777
    - Total expenditure reflected as R130,35 million in the statement of financial performance is understated by R1,17 million
    - Non–current assets reflected as R256,94 million in the statement of financial position are understated by R345 019 (2012: R122 150 overstatement)
    - Current assets reflected as R12,36 million in the statement of financial position are overstated by R366 487 (2012: R30 628 understatement)
    - Current liabilities reflected as R46,0 million in the statement of financial position are understated by R393 582 (2012: R530 360)
    - Accumulated surplus reflected as R202,40 million in the statement of changes in net assets is understated by R275 704 (2012: R90 658).

11. In addition, due to individually immaterial amounts that were unsubstantiated, I was unable to obtain sufficient appropriate audit evidence to confirm or verify the following elements by alternative means:

- General expenses included in note 38 to the financial statements in the current year
- Receivables from exchange transactions included in note 19 to the financial statements in the current and prior year
- Payables from exchange transactions included in note 9 to the financial statements in the current year
- Inventory included in note 18 to the financial statements in the current and prior year;
- Biological assets included in note 17 to the financial statements in the current and prior year.

12. As a result, I was unable to determine whether any further adjustments to these current and corresponding elements were necessary.

Qualified opinion

13. In my opinion, except for the effects and the possible effects of the matters described in the basis for qualified opinion paragraphs, the financial statements present fairly, in all material respects, the financial position of the Maletswai Local Municipality as at 30 June 2013 and its financial performance and cash flows for the year then ended, in accordance with GRAP and the requirements of the MFMA and DoRA.

Emphasis of matters

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

Restatement of corresponding figures

15. As disclosed in notes 39 and 40 to the financial statements, the corresponding figures have been restated as a result of errors only corrected during the year ended 30 June 2013 that existed in the financial statements at, and for the year ended, 30 June 2012.

Financial sustainability

16. Note 56 to the financial statements indicate that the municipality's current liabilities exceeded its current assets. This situation, along with other matters as set forth in the note, indicates that the municipality may encounter difficulty realising its assets and discharging its liabilities in the normal course of business.

Material losses

17. As disclosed in note 46.4 to the financial statements, losses of R2,43 million were incurred relating to electricity distribution.

Unauthorised expenditure

18. As disclosed in note 46.1 to the financial statements, unauthorised expenditure to the amount of R8,70 million was incurred due to overspending on votes and further unauthorised expenditure to the amount of R3,47 million was incurred as a result of the use of conditional grant funding for operational expenditure.

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

19. In accordance with the PAA and the general notice issued in terms thereof, I report the following findings relevant to performance against predetermined objectives, compliance with laws and regulations and internal control, but not for the purpose of expressing an opinion.

Predetermined objectives

20. I performed procedures to obtain evidence about the usefulness and reliability of the information in the annual performance report as set out on pages ...to..., of the annual report.

21. The reported performance against predetermined objectives was evaluated against the overall criteria of usefulness and reliability. The usefulness of information in the annual performance report relates to whether it is presented in accordance with the National Treasury's annual reporting principles and whether the reported performance is consistent with the planned key priorities and objectives. The usefulness of information further relates to whether indicators and targets are measurable (i.e. well defined, verifiable, specific, measurable and time bound) and relevant as required by the National Treasury *Framework for managing programme performance information* (FMPPI).

    The reliability of the information in respect of the selected key priority areas (KPA) is assessed to determine whether it adequately reflects the facts (i.e. whether it is valid, accurate and complete).

22. The material findings are as follows:

Usefulness of information

23. Section 46 of the Municipal Systems Act, 2000 (Act No.32 of 2000) (MSA) requires disclosure in the annual performance report of measures taken to improve performance where planned targets were not achieved. A total of 49% of the indicators relevant to the selected key priority areas were not well defined in the annual performance report. The actual achievements of the targets in relation to these indicators are therefore not accurate as a result of the indicator being poorly defined. This was due to the lack of development and implementation of proper performance planning and management practices to facilitate the development of performance indicators for inclusion into the integrated development plan (IDP).

24. Measures to improve performance for a total of 12% of the planned targets not achieved were not reflected in the annual performance report, as required by section 46 of the MSA. Management failed to identify that all instances of underperformance required the inclusion of remedial measures to improve performance. This was due to inadequate internal policies and procedures and reviews over the processes pertaining to the reporting of performance information.

25. Adequate and reliable corroborating evidence could not be provided for 39% of the measures taken to improve performance as disclosed in the annual performance report, as required by section 46 of the MSA. This was due to limitations placed on the scope of my work. The municipality's records did not permit the application of alternative audit procedures. Consequently, I did not obtain sufficient appropriate audit evidence to satisfy myself as to the reliability of the measures taken to improve performance.

26. Section 41(c) of the MSA requires that the IDP should form the basis for the annual report, therefore requiring consistency of objectives, indicators and targets between planning and reporting documents. A total of 28% of the reported objectives are not consistent with the indicators and targets as per the approved IDP. This was due to the lack of development and implementation of proper performance planning and management practices to facilitate the development of performance indicators and targets for inclusion into the IDP.

27. The FMPPI requires that performance targets be specific in clearly identifying the nature

and required level of performance. A total of 43% of the targets in relation to the selected key priority areas were not specific in clearly identifying the nature and the required level of performance. This was due to the fact that management did not correctly apply the principles contained in the FMPPI when setting targets.

28. The FMPPI requires that performance targets be measurable. The required performance could not be measured for a total of 35% of the targets relevant to the selected key priority areas. This was due to the fact that management did not correctly apply the principles contained in the FMPPI when setting targets.

29. The FMPPI requires that the time period or deadline for delivery be specified. A total of 28% of the targets relevant to the selected key priority areas were not time bound in specifying a time period or deadline for delivery. This was due to the fact that management did not correctly apply the principles contained in the FMPPI when setting targets.

30. The FMPPI requires that indicators should have clear unambiguous data definitions so that data is collected consistently and is easy to understand and use. A total of 33% of the indicators relevant to the selected key priority areas were not well defined in that clear, unambiguous data definitions were not available to allow for data to be collected consistently. This was due to the lack of development and implementation of proper performance planning and management practices to facilitate the development of performance indicators for inclusion into the IDP.

31. The FMPPI requires that it must be possible to validate the processes and systems that produce the indicator. A total of 72% of the indicators relevant to the selected key priority areas were not verifiable in that valid processes and systems that produce the information on actual performance did not exist. This was due to the lack of key controls in the relevant systems of collection, collation, verification and storage of actual performance information.

32. The FMPPI requires that the indicator should relate logically and directly to an aspect of the institution's mandate, the realisation of strategic goals and objectives. A total of 28% of indicators did not relate logically and directly to an aspect of the institution's mandate and realisation of strategic goals and objectives as per the IDP. This was due to management not appropriately defining its indicators to report on the achievement of the service provided.

Reliability of information

KPA 1: Spatial Considerations

33. The FMPPI requires that institutions should have appropriate systems to collect, collate, verify and store performance information to ensure valid, accurate and complete reporting of actual achievements against planned objectives, indicators and targets. The information presented with respect to the selected KPA 1: Spatial Considerations was not reliable when compared to the source information and evidence provided. This was due to a lack of standard operating procedures for the recording of actual achievement and inadequate monitoring and review of performance information by senior management.

KPA 2: Service Delivery

34. The FMPPI requires that institutions should have appropriate systems to collect, collate, verify and store performance information to ensure valid, accurate and complete reporting of actual achievements against planned objectives, indicators and targets. The information presented with respect to the selected KPA 2: Service Delivery was not reliable when compared to the source information and evidence provided. This was due

to a lack of standard operating procedures for the recording of actual achievement and inadequate monitoring and review of performance information by senior management.

KPA 3: Local Economic Development

35. The FMPPI requires that institutions should have appropriate systems to collect, collate, verify and store performance information to ensure valid, accurate and complete reporting of actual achievements against planned objectives, indicators and targets. I was unable to obtain the information and explanations I considered necessary to satisfy myself as to the reliability of information presented with respect to KPA 3: Local Economic Development. This was due to limitations placed on the scope of my work due to the fact that the institutions could not provide sufficient appropriate evidence in support of the information presented with respect to the programme. The institution's records did not permit the application of alternative audit procedures.

Compliance with laws and regulations

36. I performed procedures to obtain evidence that the entity has complied with applicable laws and regulations regarding financial matters, financial management and other related matters. My findings on material non-compliance with specific matters in key applicable laws and regulations as set out in the *General Notice* issued in terms of the PAA are as follows:

Strategic planning and performance management

37. The municipality did not have and maintain effective, efficient and transparent systems of financial and risk management and internal controls as required by section 62(1)(c)(i) of the MFMA.

38. The municipality did not establish adequate mechanisms to monitor and review its performance management system, as required by section 40 of the MSA.

39. The municipality did not take steps to improve performance with regard to the development priorities and objectives where performance targets were not met during the year as required by section 41(1)(c) of the MSA. This was mainly caused by the fact that the performance management system was not devised in such a way so as to monitor performance and to serve as an early warning indicator of under-performance as required by section 41(2) of the MSA.

Annual financial statement and annual reports

40. 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 non-current assets, non-current liabilities, current liabilities, current assets, revenue, expenditure and disclosure items identified by the auditors in the submitted financial statements were subsequently corrected and the supporting records were subsequently provided, but the uncorrected material misstatements and supporting records that could not be provided resulted in the financial statements receiving a qualified audit opinion.

Budgets

41. Expenditure was incurred not in terms of the approved budget and in excess of the limits of the amounts provided for in the votes of the approved budget, in contravention of section 15 of the MFMA.

Human resource management

42. Appointment was made in posts which were not provided for in the approved staff establishment of the municipality, in contravention of section 66(3) of the MSA.

43. The municipality did not submit a report on compliance with prescribed competency levels to the National Treasury and the Eastern Cape Provincial Treasury, as required by the Municipal Regulations on Minimum Competency Levels issued in *Government Gazette 29967* of 15 June 2007 (MRMCL), regulation 14(2)(a).

44. The accounting officer did not meet all the prescribed competency areas as required by section 83 of the MFMA and regulations 2 and 3 of the MRMCL.

45. Senior managers did not meet all the prescribed competency areas, as required by regulations 6 and 7 of the MRMCL.

46. One senior manager did not achieve the higher education qualification, as required by regulations 6 and 7 of the MRMCL.

47. Financial officials at middle management did not meet all the prescribed competency areas as required by regulations 8 and 9 of the MRMCL.

48. The annual report of the municipality did not reflect information on compliance with prescribed minimum competencies, as required by MRMCL regulation 14(2)(b).

49. One senior manager directly accountable to the municipal manager did not sign a performance agreement within 60 days of appointment, as required by section 57(2)(a) of the MSA.

50. Sufficient appropriate audit evidence could not be obtained to confirm that:

- the chief financial officer met all the prescribed competency areas as required by section 83 of the MFMA and regulations 4 and 5 of the MRMCL

- the head of supply chain management met all the prescribed competency areas as required by section 119 of the MFMA and the regulations 10 and 11 of the MRMCL

- financial officials at middle management met all the prescribed competency areas as required by regulations 8 and 9 of the MRMCL.

Audit committee

51. The audit committee did not advise the council and the accounting officer on matters relating to internal financial control and internal audits, risk management, accounting policies, effective governance, performance management and performance evaluation, as required by section 166(2)(a) of the MFMA.

52. The audit committee did not review quarterly internal audit reports on performance measurement, as required by the Municipal Planning and Performance Management Regulation (MPPMR) 14(4)(a)(i).

53. The audit committee did not adequately review the municipality's performance management system and make recommendations to the council, as required by the MPPMR 14(4)(a)(ii).

54. The audit committee did not submit, at least twice during the financial year, an audit report on the review of the performance management system to the council, as required by the MPPMR 14(4)(a)(iii).

Internal audit unit

55. The internal audit unit did not function as required by section 165(2) of the MFMA, in that it did not report to the audit committee on the implementation of the internal audit plan and it did not effectively advise the accounting officer and report to the audit committee on matters relating to internal audit, internal controls, accounting procedures and practices, risk and risk management and loss control.

56. The internal audit unit did not adequately and continuously assess the functionality of the performance management system, as required by the MPPMR 14(1)(b)(i).

57. The internal audit unit did not submit quarterly reports on their audits to the performance audit committee, as required by the MPPMR 14(1)(c).

Expenditure management

58. 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.

59. Reasonable steps were not taken to prevent unauthorised, irregular and fruitless and wasteful expenditure, as required by section 62(1)(d) of the MFMA.

Conditional grants expenditure

60. The municipality did not evaluate its performance in respect of programmes funded by the Local Government Financial Management Grant and submit the evaluation to the transferring national officer within two months after the end of the financial year, as required by section 12(5) of the DoRA.

61. The municipality did not submit within 10 days after the end of February 2013, its monthly expenditure reports to the national Department of Cooperative Governance and Traditional Affairs (CoGTA), as required by the Division of Revenue Grant Framework, issued in *Government Gazette No.35399* of 31 May 2012 (DoRGF).

Asset management

62. An adequate management, accounting and information system that accounts for assets was not in place, as required by section 63(2)(a) of the MFMA.

63. An effective system of internal control for assets was not in place, as required by section 63(2)(c) of the MFMA.

Consequence management

64. Unauthorised, irregular and fruitless and wasteful expenditure incurred by the municipality was not investigated to determine if any person was liable for the expenditure, in accordance with the requirements of section 32(2) of the MFMA.

Procurement and contract management

65. Quotations were accepted from prospective providers who were not registered on the list of accredited prospective providers and did not meet the listing requirements prescribed by the SCM policy, in contravention of SCM Regulation, regulations 16(a) and 17(a).

66. Contracts were awarded to bidders based on preference points that were not allocated and calculated in accordance with the requirements of the Preferential Procurement Policy Framework Act, 2000 (Act No. 5 of 2000) (PPPFA) and its regulations.

Internal control

67. I considered internal control relevant to my audit of the financial statements, the annual performance report and compliance with laws and regulations. The matters reported below under the fundamentals of internal control 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

68. There is a lack of oversight and accountability by the leadership and senior management to ensure consistent implementation and monitoring of daily, weekly and monthly controls over financial reporting, performance information and compliance with laws and regulations. The extent of material misstatements identified suggests that the municipality relies heavily on the audit process rather than its own management processes to detect and correct misstatements. This is not suitable in promoting sustainable financial reporting.

69. The weaknesses and deficiencies in the control environment of the municipality that were reported in previous years have not been adequately addressed. This is mainly due to prior period audit recommendations not being adequately resolved and the late implementation and monitoring of action plans.

70. The shortage of in-house skills and competencies resulted in the municipality having to appoint consultants every year to prepare the financial statements. There was no system to ensure that there was sufficient transfer of skills to permanent finance staff members to eventually eliminate the need to appoint consultants in performing management functions.

71. An information technology (IT) action plan has not been developed and instituted to address the ever-growing risk in the IT environment of the municipality. IT did not play a role in financial oversight, even though this area could have been developed to assist with the monitoring of variances associated with good performance and financial management. This situation remained unchanged largely due to lack of capacity within the IT department and inefficient reporting to senior management. Misstatements that could have been avoided were therefore not prevented or identified, which has led to material misstatements not being corrected.

Financial and performance management

72. There were ineffective record management and filing systems for both financial and performance reporting resulting in documentation that was lacking in quality and completeness. In addition, the municipality did not fully implement and adequately monitor all the appropriate daily and monthly processes, procedures and controls to ensure the credibility of information used to prepare the financial statements and annual performance report. These are contributing factors to the numerous misstatements identified.

73. The municipality did not have systems in place to monitor compliance with applicable legislation. Non-compliance with laws and regulations could have been prevented had compliance been properly reviewed and monitored, particularly with respect to procurement. There is a lack of supervision, monitoring and consequence management in respect of the financial and performance reporting process.

Governance

74. The risk assessment process was incomplete as it did not take into account all risks, especially new requirements of the reporting framework and performance information.

75. Internal audit did not complete all assignments per their audit plan. The plan was not monitored throughout the period to ensure that the key risks were addressed, which contributed to the overall lack of credibility of the information included in the financial statements and annual performance report.

76. The audit committee was not given sufficient time to discharge its function of reviewing the accuracy, reliability and adequacy of the financial statements and, as a result, the review performed on the annual financial statements did not have the desired impact on the fair presentation thereof. Quarterly internal audit reports on performance information were not submitted to the audit committee for review. The audit committee was therefore restricted in their ability to report and make recommendations to the council on the functionality of the municipality's performance management system.

Auditor - General

East London

29 November 2013

AUDITOR-GENERAL
SOUTH AFRICA

Auditing to build public confidence