

# REPORT OF THE AUDITOR-GENERAL TO EASTERN CAPE PROVINCIAL LEGISLATURE AND COUNCIL OF BLUE CRANE ROUTE MUNICIPALITY

## REPORT ON THE CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS

### Introduction

1. I have audited the consolidated and separate financial statements of the Blue Crane Route Municipality set out on pages XX to XX, which comprise the consolidated statement of financial position as at 30 June 2014, the consolidated statement of financial performance, statement of changes in net assets, cash flow statement and the statement of comparison of budget and actual amounts for the year then ended, as well as 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 consolidated and separate financial statements in accordance with the 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 Division of Revenue Act of South Africa, 2013 (Act No. 2 of 2013) (DoRA), and for such internal control as the accounting officer determines is 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. My responsibility is to express an opinion on these consolidated and separate 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 consolidated financial statements are free from material misstatement.
4. 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 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.
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

#### Property, plant and equipment

6. The municipality applied *Directive 7: The application of deemed cost on the adoption of Standards of GRAP* and made use of deemed costs to value property, plant and equipment. The municipality did not have adequate systems in place to ensure the fixed

asset register agreed to the underlying accounting records, which resulted in infrastructure assets included in property, plant and equipment being overstated by R4,8 million in the current and prior year. Additionally, there is a consequential overstatement of the depreciation expense for the period and the accumulated surplus. In addition, I was unable to obtain sufficient appropriate audit evidence for the amounts disclosed as cost, accumulated depreciation, related depreciation expense and carrying values of infrastructure assets for the current year and the prior year as disclosed in note 12 to the financial statements. Consequently, I was unable to determine whether any adjustment relating to infrastructure assets stated as R594 million (2012-13: R611 million) in the consolidated and separate financial statements was necessary.

7. The municipality did not recognise property, plant and equipment in terms of *GRAP 17: Property, Plant and Equipment*. A number of properties were identified from the deeds search that are not included in the municipality's fixed asset register. There are also certain assets which are listed on the fixed asset register that were not included in the deeds search results. Consequently, land and buildings included in property, plant and equipment as disclosed in note 12 is understated by R1,7 million (2012-13 R1,4 million). Additionally, there is a consequential understatement of accumulated surplus.

#### **Investment property**

8. The municipality did not recognise investment property in terms of *GRAP 16: Investment Property*. A number of properties were identified from the deeds search that are not included in the municipality's investment property schedule. There are also certain properties that are listed on the investment property schedule that were not included in the deeds search results. Consequently, investment property is understated by R36 million (2012-13: R32 million). Additionally, there is a consequential understatement of surplus for the period and the accumulated surplus.

#### **Distribution losses**

9. In the prior year the municipality did not include particulars of water distribution losses for Cookhouse and Pearston in the notes to the consolidated and separate financial statements, as required by section 125(2)(d) of the MFMA. I was unable to confirm the distribution losses for water by alternative means. Therefore I have not quantified the misstatement as it is impracticable to do so. The auditor's opinion has been modified because of the possible effects of the unresolved matter on the comparability of the current year's figures and the corresponding figures.

#### **Irregular expenditure**

10. The municipality did not have adequate systems in place to identify and disclose all irregular expenditure incurred during the year as required by section 125(2)(d)(i) of the MFMA. The municipality did not include particulars of irregular expenditure in the notes to the consolidated and separate financial statements, as required by section 125(2)(d)(i) of the MFMA. The municipality made payments in contravention of the supply chain management requirements that were not included in irregular expenditure, resulting in irregular expenditure being understated by at least R22,1 million (2012-13: R2,6 million). Due to the inadequate systems in place, it was impracticable for me to determine the full extent of the understatement of irregular expenditure. Consequently, I was unable to determine whether any adjustments were necessary to the irregular expenditure disclosed in note 47 at R33,1 million (2012-13: R24 million).

### **Basis of preparation**

11. *GRAP 3: Accounting policies, changes in accounting estimates and errors* requires the preparers of the consolidated and separate financial statements to disclose the nature of prior period errors. The municipality did not adequately disclose the nature of the prior period errors and the adjustment to the comparative figures disclosed in notes 41 of the consolidated and separate financial statements.

### **Aggregation of immaterial uncorrected misstatements in corresponding figures**

12. The corresponding amounts in the consolidated and separate financial statements are materially misstated due to the cumulative effect of numerous individually immaterial uncorrected misstatements in the following items making up the statement of financial position and the notes to the consolidated and separate financial statements:

- Inventories reflected as R1,5 million is understated by R24 573.
- Payables from exchange transactions reflected as R16,8 million is understated by R611 974.
- Vat payable reflected as R1,1 million is understated by R28 378.
- Other receivables from exchange transactions reflected as R646 252 is understated by R668 705.
- Property, plant and equipment reflected as R673,5 million is understated by R1,3 million.
- Provisions reflected as R24,9 million is understated by R87 500.
- Unspent conditional grants and receipts reflected as R7,4 million is overstated by R24 635.

### **Qualified opinion**

13. In my opinion, except for the effects of the matters described in the basis for qualified opinion, the consolidated and separate financial statements present fairly, in all material respects, the financial position of the Blue Crane Route Municipality as at 30 June 2014 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 note 41 to the consolidated and separate financial statements, the corresponding figures for 30 June 2013 have been restated as a result of errors discovered during the current financial period in the financial statements of the municipality at, and for the year ended, 30 June 2013 and 30 June 2012.

### **Material losses/Impairments**

16. As disclosed in note 7 and 8 to the consolidated and separate financial statements, other receivables from non-exchange transactions and trade receivables from exchange transactions were impaired by R2 million and R21,8 million respectively as it is unlikely that the municipality will recover the amount from the debtors.
17. As disclosed in note 26 to the consolidated and separate financial statements, electricity losses of 27% and water losses of 42% were incurred during the financial year.

### **Irregular expenditure**

18. As disclosed in note 47 to the consolidated and separate financial statements, irregular expenditure to the amount of R9,1 million (2012-13: R20,4 million) was incurred as a result of contravention of the supply chain management requirements.

### **Additional matter**

### **Unaudited disclosure notes**

19. In terms of section 125(2)(e) of the MFMA the municipality is required to disclose particulars of non-compliance with this legislation. This disclosure requirement did not form part of the audit of the consolidated and separate financial statements and accordingly I do not express an opinion thereon.

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

20. In accordance with the PAA and the general notice issued in terms thereof, I report the following findings on the reported performance information against predetermined objectives for selected development priorities or objectives presented in the annual performance report, non-compliance with legislation as well as internal control. The objective of my tests was to identify reportable findings as described under each subheading but not to gather evidence to express assurance on these matters. Accordingly, I do not express an opinion or conclusion on these matters.

### **Predetermined objectives**

21. I performed procedures to obtain evidence about the usefulness and reliability of the reported performance information for the service delivery and infrastructure development objective presented in the annual performance report on pages XX to XX of the municipality for the year ended 30 June 2014.
22. I evaluated the reported performance information against the overall criteria of usefulness and reliability.
23. I evaluated the usefulness of the reported performance information to determine whether it was presented in accordance with the National Treasury's annual reporting principles and whether the reported performance was consistent with the planned development priorities or objectives. I further performed tests to determine whether indicators and targets were well defined, verifiable, specific, measurable, time bound and relevant, as required by the *National Treasury's Framework for managing programme performance information* (FMPPI).
24. I assessed the reliability of the reported performance information to determine whether it was valid, accurate and complete.
25. The material findings in respect of the selected development priorities or objectives are as follows:

### **Service delivery and infrastructure development**

#### **Usefulness of reported performance information**

26. Performance indicators must be verifiable, meaning that it must be possible to validate the processes and systems that produced the indicator. Twenty six percent of

significantly important indicators were not verifiable. These findings were due to management not adhering to the requirements of the FMPPI as there is a lack of proper performance management systems and processes in place and no technical indicator descriptions for all indicators and targets.

#### **Reliability of reported performance information**

27. The FMPPI requires auditees to 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. Significantly important targets were not reliable when compared to the source information or evidence provided. This was due to a lack of standard operating procedures or documented system descriptions for the accurate recording of actual achievements and technical indicator descriptions for the accurate measurement, recording and monitoring of performance.

#### **Additional matters**

28. I draw attention to the following matter:

#### **Achievement of planned targets**

29. Refer to the annual performance report on pages XX to XX for information on the achievement of planned targets for the year. This information should be considered in the context of the material findings on the usefulness and reliability of the reported performance information for the selected objective reported in paragraphs 26 and 27 of this report.

#### **Compliance with legislation**

30. I performed procedures to obtain evidence that the municipality had complied with applicable legislation regarding financial matters, financial management and other related matters. My findings on material non-compliance with specific matters in key legislation, as set out in the general notice issued in terms of the PAA, are as follows:

#### **Financial statements and annual report**

31. 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 MFMA. Material misstatements of non-current assets, accumulated surplus and disclosure items identified by the auditors in the submitted consolidated and separate financial statements were subsequently corrected and the supporting records were provided subsequently, but the uncorrected material misstatements and supporting records that could not be provided resulted in the consolidated and separate financial statements receiving a qualified audit opinion.

#### **Strategic planning and performance management**

32. Measurable performance targets for the financial year with regard to each of the objectives and key performance indicators were not set in the integrated development plan (IDP), as required by section 41(1)(b) of the MSA and the Municipal planning and performance management regulations, 2001 (Government Gazette 22605 of 2001) (MPPMR) 12(1) and 12(2)(e).

33. The adopted IDP did not reflect and identify a financial plan and the key performance indicators and targets, as required by sections 26 and 41 of the MSA, as well as the MPPMR 2(1)(c).

34. The local community was not afforded the opportunity to comment on the final draft of the IDP before adoption, as required by section 42 of the MSA and MPPMR 9, 13(1), 13(4)(c) and 15(3).
35. The IDP was not annually reviewed based on the assessment of its performance measurements and changing circumstances, as required by section 34 of the MSA and MPPMR 3 and 11.
36. Key performance indicators, including input, output and outcome indicators, in respect of each of the development priorities and objectives were not set out in the IDP, as required by section 41(1)(a) of the MSA and the MPPMR 1 and 9(1)(a).
37. The performance of the municipality were not assessed during the first half of the financial year, as required by section 72(1)(a)(ii) of the MFMA.
38. The annual performance agreements for the municipal manager and all senior managers are not linked to the measurable performance objectives approved with the budget and to the service delivery budget implementation plan (SDBIP) as required in terms of section 53(1)(c)(iii) of the MFMA and section 57(1)(b) of the MSA.
39. The performance management system and its related controls were inadequate as it did not describe and represent the processes of performance (planning, monitoring, measurement, review, reporting and improvement) and how it is conducted, organised and managed, as required by sections 38 of the MSA and regulation 7 of the MPPMR.

#### **Asset management**

40. An adequate management, accounting and information system which accounts for assets was not in place, as required by section 63(2)(a) of the MFMA.
41. An effective system of internal control for assets (including an asset register) was not in place, as required by section 63(2)(c) of the MFMA.

#### **Liability Management**

42. The municipality issued guarantees for debts of the Department of Minerals and Energy which were not provided for in the approved budget, in contravention of section 50(a) of the MFMA.
43. Securities were issued without a resolution by the municipal council, as required by section 48(1) of the MFMA.
44. The municipality issued securities for purposes other than those provided for in section 48(1) of the MFMA.

#### **Expenditure Management**

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

#### **Procurement and contract management**

46. Sufficient appropriate audit evidence could not be obtained that all contracts and/ or quotations were awarded in accordance with the legislative requirements and a procurement process which is fair, equitable, transparent and competitive, as supporting documentation could not be provided.
47. Goods and services with a transaction value of below R200 000 were procured without obtaining the required price quotations as required by SCM regulation 17(a) and (c).
48. Bid adjudication was not always done by committees which were composed in accordance with SCM regulation 29(2).

49. 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 of South Africa, 2000 (Act No. 5 of 2000) and SCM regulation 28(1)(a).
50. Contracts and quotations were awarded to bidders who did not submit a declaration on whether they are employed by the state or connected to any person employed by the state, as required by SCM regulation 13(c).
51. Construction projects were not always registered with the Construction Industry Development Board (CIDB), as required by section 22 of the CIDB Act and CIDB regulation 18.
52. Contracts were extended and modified without tabling the reasons for the proposed amendment in the council of the municipality, as required by section 116(3) of the MFMA.
53. Contracts and quotations were awarded 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.

#### **Consequence management**

54. Unauthorised, Irregular and Fruitless and wasteful expenditure incurred by the municipality was not investigated to determine if any person is liable for the expenditure, as required by section 32(2)(a)(ii) of the MFMA.

#### **Human resource management**

55. Job descriptions were not established for all posts in which appointments were made in the current year, in contravention of section 66(1)(b) of MSA.
56. Sufficient appropriate audit evidence could not be obtained that newly appointed managers directly accountable to the municipal manager submitted proof of previous employment prior to appointment as per the requirements of regulation 4 of GNR 805.
57. Sufficient appropriate audit evidence could not be obtained that the senior managers dismissed for financial misconduct in a previous position and re-appointed before the expiry of 10 years in contravention of section 57A of the MSA.
58. The competencies of financial and/or supply chain management officials were not assessed in a timely manner in order to identify and address gaps in competency levels as required by the Municipal Regulations on Minimum Competency Levels regulation 13.
59. The municipality did not submit a report on compliance with prescribed competency levels to the National Treasury and relevant provincial treasury as required by the Regulations on Minimum Competency Levels regulation 14(2)(a).
60. The municipality did not develop and adopt appropriate systems (policies) and procedures to monitor measure and evaluate performance of staff in contravention of MSA section 67(d).

#### **Budgets**

61. Expenditure was not incurred in accordance with the approved budget and was incurred 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.

#### **Audit Committee**

62. The audit committee did not advise the council and the accounting officer on matters relating to performance management and performance evaluation as required by section 166(2)(a) of the MFMA.

63. The audit committee did not review the municipality's performance management system and make recommendations to the council, as required by Municipal planning and performance management regulation 14(4)(a)(ii).
64. The audit committee did not review all the quarterly internal audit reports on performance measurement, as required by Municipal planning and performance management regulation 14(4)(a)(i).
65. 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 Municipal planning and performance management regulation 14(4)(a)(iii).

#### **Internal Audit**

66. The internal audit unit did not function as required by section 165(2) of the MFMA, in that it did not advise the accounting officer and report to the audit committee on matters relating to internal controls, accounting procedures and practices and loss control.
67. The internal audit unit did not advise the accounting officer and report to the audit committee on matters relating to compliance with the MFMA, the DoRA and other applicable legislation, as required by section 165(2)(b)(vii) of the MFMA.

#### **Internal control**

68. I considered internal control relevant to my audit of the consolidated and separate financial statements, annual performance report and compliance with legislation. The matters reported below are limited to the significant internal control deficiencies that resulted in the basis for qualified opinion, the findings on the annual performance report and the findings on non-compliance with legislation included in this report.

#### **Leadership**

69. The effectiveness of leadership in the current year is concerning with regards to guiding the municipality's activities and setting the tone for its daily operations at all functional levels. Sixty percent of the senior manager positions were vacant for a portion of the year, which has had a negative effect on the leadership structure. Oversight responsibility has been negatively affected by the high vacancy rate at the municipality, as accountability is undermined by the instable leadership structure.
70. There was a lack of consequence management and recourse taken by oversight mechanisms to address transgressions in laws and regulations governing procurement and supply chain management processes. There is no evidence that leadership has followed up or investigated transgressions by officials. Leadership's inability to address and prioritise this critical area has a direct bearing on the number of compliance findings reported.
71. Policies and procedures are either not implemented or not monitored, and the deficiencies identified in the previous audit have not been addressed, symptomatic of a slow response to and inadequate monitoring of our prior year messages. This is indicative of a leadership structure not managing the affairs of the municipality, the result being the numerous material misstatements identified in the financial statements and the lack of effective service delivery as evidenced by the material findings on the reliability of the annual performance report.

#### **Financial and performance management**

72. The consolidated and separate financial statements contained material misstatements. This was mainly due to staff members not fully understanding the requirements of the financial reporting framework and the municipality still having to appoint external parties



to compile the fixed asset registers due to a shortage or lack of in-house skills and competencies. However, the municipality must adopt a proper strategy to ensure that the opportunity exists for the necessary skills transfer to the responsible employees.

73. There is an inadequate control environment at the municipality over proper record keeping and reporting occurring in non-current assets and liabilities. This has resulted in the qualified opinion on the financial statements and the material findings on the annual performance report. Management relied on external parties to compile underlying accounting records for the financial statements, not ensuring that the underlying information can be relied upon through the proper review. The consolidated and separate financial statements were therefore submitted for audit containing material misstatements that were not identified by the municipality's own system of control.

#### **Governance**

74. Due to the breakdown of assurance structures within the municipality in performing their roles and responsibilities effectively, there has been inadequate response to mitigate the risks identified by management, internal audit, external audit and those charged with governance from the current and prior years. The internal audit function was inadequately resourced and therefore could not function effectively for a part the financial year. Action plans to address risks identified by the municipality's internal audit department have not been effectively implemented. The audit committee cannot be considered effective without a well-functioning internal audit unit within the municipality. In addition, the audit committee does not hold management accountable for not implementing the recommendations that are made by internal and external audit.

*Auditor General*

East London

12 December 2014



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