

Report of the auditor-general to the Eastern Cape Provincial Legislature and the council on the Buffalo City Metropolitan Economic Entity

Report on the consolidated financial statements

Introduction

1. I have audited the consolidated financial statements of the Buffalo City Metropolitan Economic Entity set out on pages ... to ..., which comprise the consolidated statement of financial position as at 30 June 2015, the statement of financial performance, statement of changes in net assets, cash flow statement and 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 consolidated financial statements

2. The accounting officer is responsible for the preparation and fair presentation of these consolidated 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 the Division of Revenue Act of South Africa, 2014 (Act No. 10 of 2014) (DoRA), and for such internal control as the accounting officer determines is necessary to enable the preparation of consolidated 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 financial statements based on my audit. I conducted my audit in accordance with 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 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 municipality's preparation and fair presentation of the consolidated 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 municipality'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 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

Irregular expenditure

6. Section 125(2)(d)(i) of the MFMA requires the municipality to disclose irregular expenditure in the notes to the consolidated financial statements. Irregular expenditure disclosed in note 54 to the consolidated financial statements at R479 million (2013-14: R724 million) was understated by at least R156 million (2013-14: R18 million) as a result of the municipality not having an adequate system to allocate payments made to the contracts awarded. Due to the inadequate system, it was impracticable for me to determine the full extent of the understatement. Accordingly, I was unable to determine whether any further adjustments were necessary to the irregular expenditure disclosure note.

Commitments

7. The municipality did not accurately disclose all capital expenditure commitments, as required by GRAP 17 *Property, plant and equipment*. Commitments were calculated using the incorrect contract and payment values. In addition, certain capital expenditure contracts were excluded from the commitments listing. Consequently, commitments as disclosed in note 45 to the consolidated financial statements were overstated by at least R75 million (2013-14: R60 million).

Qualified opinion

8. In my opinion, except for the effects of the matters described in the basis of qualified opinion paragraphs, the consolidated financial statements present fairly, in all material respects, the financial position of the Buffalo City Metropolitan Economic Entity as at 30 June 2015 and its financial performance and cash flows for the year then ended, in accordance with SA Standards of GRAP and the requirements of the MFMA and DoRA.

Emphasis of matters

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

Impairments

10. As disclosed in note 7 to the consolidated financial statements, cumulative debt impairment provisions of R900 million (2013-14: 686 million) have been disclosed. This amount excludes bad debts written off relating to receivables from exchange transactions of R124 million (2013-14: R88 million) and receivables from non-exchange transactions of R27 million (2013-14: R32 million) as disclosed in notes 7 and 8 to the consolidated financial statements, respectively.
11. As disclosed in the statement of financial performance and note 35 to the consolidated financial statements, debt impairments totalling R365 million (2013-14: R241 million) have been expensed.

Material losses

12. The municipality incurred material losses as disclosed in note 56 to the consolidated financial statements. These included the following:

- Electricity losses totalling R163 million (2013-14: R150 million), of which non-technical losses comprised R95 million (2013-14: R88 million)
- Water losses totalling R99 million (2013-14: R90 million), of which non-technical losses comprised R13 million (2013-14: R22 million)

Unauthorised expenditure

13. As disclosed in note 52 to the consolidated financial statements, unauthorised expenditure of R245 million (2013-14: R172 million) was incurred as a result of overspending on debt impairment; depreciation and asset impairments; finance charges; transfers and grants due to the increase in the indigent register; and transfers between operating and capital expenditure.

Significant uncertainty

14. The municipality is a defendant in a number of lawsuits to the amount of R153 million (2013-14: R116 million) as disclosed in note 60 to the consolidated financial statements. The outcome of these lawsuits cannot be determined at present, as litigation is still in progress.

Restatement of corresponding figures

15. As disclosed in note 48 to the consolidated financial statements, the corresponding figures for 30 June 2014 have been restated as a result of errors discovered during the current financial year.

Additional matter

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

Unaudited disclosure notes

17. 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 financial statements and, accordingly, I do not express an opinion thereon.

Report on other legal and regulatory requirements

18. In accordance with the Public Audit Act of South Africa, 2004 (Act No. 25 of 2004) (PAA) and the general notice issued in terms thereof, I have a responsibility to report findings on the reported performance information against predetermined objectives for selected key performance areas (KPAs) presented in the annual performance report, compliance with legislation and 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

19. I performed procedures to obtain evidence about the usefulness and reliability of the reported performance information for KPA 2: basic service delivery and infrastructure development on pages x to x, presented in the annual performance report of the municipality for the year ended 30 June 2015.
20. I evaluated the reported performance information against the overall criteria of usefulness and reliability.
21. 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 KPA. 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 (FMPPPI)*.
22. I assessed the reliability of the reported performance information to determine whether it was valid, accurate and complete.
23. I did not raise any material findings in respect of the usefulness of the reported performance information for KPA 2: basic service delivery and infrastructure development.
24. The material finding in respect of the reliability of KPA 2: basic service delivery and infrastructure development is as follows:

KPA 2: basic service delivery and infrastructure development

Reliability of reported performance information

25. The FMPPPI 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. Overall, significantly important targets were not reliable, as I was unable to obtain sufficient appropriate audit evidence for significantly important targets. In addition, significantly important targets were not valid, accurate and complete when compared to the source information or evidence provided. Some information submitted did not agree with the annual performance report and, in some instances, the reported information was misstated.

Additional matters

26. I draw attention to the following matters:

Achievement of planned targets

27. Refer to the annual performance report on pages x to x for information on the achievement of planned targets for the year. This information should be considered in the context of the findings raised on the reliability of the reported performance information in paragraph 25 of this report.

Unaudited supplementary schedules

28. The supplementary information set out on pages XX to XX does not form part of the annual performance report and is presented as additional information. I have not audited these schedules and, accordingly, I do not report thereon.

Compliance with legislation

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

Strategic planning and performance management

30. 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 they are conducted, organised and managed, as required by section 38 of the Municipal Systems Act of South Africa, 2000 (Act No. 32 of 2000) (MSA) and municipal planning and performance management regulation 7.

Annual consolidated financial statements

31. The consolidated 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 in the statement of financial position, financial performance and disclosure items identified by the auditors in the submitted consolidated financial statements were subsequently corrected, but the uncorrected material misstatements resulted in the consolidated financial statements receiving a qualified audit opinion.

Procurement and contract management

32. Contracts and quotations were awarded to bidders based on preference points that had not been allocated or calculated in accordance with the requirements of the Preferential Procurement Policy Framework Act of South Africa, 2000 (Act No. 5 of 2000) and its regulations.

33. The contract performance and monitoring measures and methods were insufficient to ensure effective contract management, as required by section 116(2)(c) of the MFMA.

34. Related party non-compliance was identified in the following instances:

- Persons in the service of the municipality or close family members who had a private or business interest in contracts awarded by the municipality failed to disclose such interest, contrary to supply chain management (SCM) regulation 46(2)(e) issued in terms of the MSA.
- Awards were made to providers who are in the service of other state institutions or whose directors or principal shareholders are in the service of other state institutions, in contravention of section 112(j) of the MFMA and SCM regulation 44. Similar awards were identified in the prior year and no effective steps had been taken to prevent or combat the abuse of the SCM process, contrary to SCM regulation 38(1).
- Persons in the service of the municipality who had a private or business interest in contracts awarded by the municipality failed to disclose such interest, contrary to SCM regulation 46(2)(e) and the code of conduct for staff members issued in terms of the MSA.
- Persons in the service of the municipality whose close family members had a private or business interest in contracts awarded by the municipality failed to disclose such interest, contrary to SCM regulation 46(2) and the code of conduct for staff members issued in terms of the MSA.

Expenditure management

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

36. Money owing by the municipality was not always paid within 30 days or an agreed period, as required by section 65(2)(e) of the MFMA.

Conditional grants received

37. Unspent funds from the urban settlements development grant and the local government financial management grant were retained for rollover to the next financial year without seeking the approval of the National Treasury, contrary to section 22(1) of DoRA.

Asset management

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

Consequence management

39. Unauthorised, irregular as well as fruitless and wasteful expenditure incurred by the municipality was not investigated to determine whether any person was liable for the expenditure, as required by section 32(2)(a)(ii) of the MFMA.

Internal control

40. I considered internal control relevant to my audit of the consolidated 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 the qualified opinion, the findings on the annual performance report and the findings on compliance with legislation included in this report.

Leadership

41. Commitments made by the leadership to fill critical senior and middle management positions were not met. The continued absence of permanent officials to lead and guide the municipality compromised the effectiveness and stability of the control environment. As a result, performance management was not adequately implemented and monitored, while consequence management was not always applied where necessary.
42. There was a lack of integration and alignment within the municipality, as the different directorates planned, worked and reported in isolation. The municipality relied on manual processes to account for capital work in progress and commitments. Although the leadership committed to a project management tool in this regard, it was not implemented.
43. The leadership did not sufficiently address the previously reported challenges faced by the municipality's SCM unit. This was largely as a result of inadequate capacity within the SCM unit, which resulted in poor record keeping and monitoring throughout the year. Poor planning, implementation and monitoring of contracts by user directorates within the municipality also contributed towards the material findings reported in this report.

Financial and performance management

44. The municipality did not fully implement and monitor all required daily and monthly financial, performance and compliance disciplines to verify the credibility of in-year reporting. This resulted in key reconciliations and processing only being performed after the financial year-end.
45. The municipality did not implement an effective performance management system that enabled the leadership to hold all officials accountable for financial and performance reporting as well as compliance with laws and regulations.
46. Furthermore, there was a lack of processes to ensure compliance with laws and regulations. As a result, management did not effectively monitor and address areas of non-compliance during the year.

Governance

47. A risk assessment was conducted by the municipality, but the risks identified in this assessment were not appropriately mitigated by the control environment.

48. The internal control deficiencies identified by the internal audit unit and the recommendations made by both the internal audit unit and the audit committee were not adequately addressed by management. This had an impact on the effectiveness of these parties in executing their duties.

Other reports

Investigations

49. The following investigations are in progress or had been finalised at the date of my report:

- An independent consulting firm performed an investigation at the request of the council, which was initiated after year-end. The investigation was initiated based on an allegation of human resource and supply chain irregularities. The investigation concluded on 13 November 2015 and resulted in disciplinary proceedings being instituted against the city manager. These proceedings are currently in progress.
- The State President signed a proclamation after year-end to institute an investigation into the procurement processes relating to two awards by the Special Investigations Unit. The investigation is currently in progress.
- The National Treasury conducted an investigation into irregular contracts and debt write-offs during the financial year, and the report on the investigation was issued to the council after year-end. The council is evaluating the recommendations of the report and instituting further action in this regard.
- The member of the executive council for local government and traditional affairs and the Directorate for Priority Crime Investigation are investigating allegations of irregularities with respect to state funeral procurement. This investigation was pending at year-end and a criminal case is ongoing.

Auditor-General

East London

9 December 2015



AUDITOR - GENERAL
SOUTH AFRICA

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