

# Report of the auditor-general to the Eastern Cape Provincial Legislature and the council on Nkonkobe Local Municipality

## Report on the financial statements

### Introduction

1. I have audited the financial statements of the Nkonkobe Local Municipality set out on pages ... to ..., which comprise the statement of financial position as at 30 June 2015, the 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 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 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 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 municipality'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 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 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.

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## Basis for qualified opinion

### Property, plant and equipment

6. In terms of *GRAP 17, Property plant and equipment*, the cost of an item of property, plant and equipment shall be recognised as an asset if it is probable that future economic benefits or service potential associated with the item will flow to the entity, and the cost or fair value of the item can be measured reliably. In addition *GRAP 13, Leases*, assets and liabilities shall be recognised at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease. The municipality did not:
- Recognise all items of property, plant and equipment from which future economic benefits will flow to the entity.
  - Exclude all refundable purchase taxes from the cost of all property, plant and equipment recognised during the financial year.
  - Accurately record depreciation on all items on property, plant and equipment.
  - Accurately recognise all items of finance leased property, plant and equipment at the lower of fair value or the present value of the minimum lease payments, determined at the inception of the lease.
7. As a result, property, plant and equipment, disclosed in note 4 to the financial statements is understated by R6,6 million and accumulated surplus is understated by the same amount. In addition work in progress, included in the balance of property, plant and equipment is overstated by R4,3 million (2014: R17,8 million) and additions to property, plant and equipment is understated by the same amount.
8. In addition, I was unable to obtain sufficient, appropriate audit evidence that management had properly accounted for property, plant and equipment disclosed in the statement of financial position and in note 4 to the financial statements due to inadequate record management. I was unable to confirm the balance of property, plant and equipment by alternative means. Consequently, I was unable to determine whether any adjustment was necessary to property, plant and equipment stated at R289 million in the financial statements.

### Irregular expenditure

9. Irregular expenditure of R30,7 million is disclosed in note 40. The municipality's process for the recording and recognition of irregular expenditure was insufficient as amounts were not recorded and the disclosure was incomplete. Consequently, irregular expenditure is understated by R8,9 million. Due to the lack of systems, it was impracticable to determine the full extent of the understatement of irregular expenditure. I was unable to confirm the disclosure by alternative means. Consequently, I was unable to determine whether any further adjustment to irregular expenditure as disclosed in note 40 was necessary.

## Investment property

10. In terms of *GRAP 16, Investment property*, investment property is property held to earn rentals or for capital appreciation or both. Investment property shall be recognised as an asset when, it is probable that the future economic benefits or service potential that are associated with the investment property will flow to the entity; and the cost or fair value of the investment property can be measured reliably. The municipality:
- Incorrectly classified owner occupied property as investment property.
  - Did not include all items of investment property to which it has title in the investment property register.
  - Incorrectly included items of investment property to which it does not have title in the investment property register.
11. As a result, investment property, disclosed in note 3 to the financial statements is understated. Due to the lack of systems, it was impracticable to determine the full extent of the understatement of investment property.
12. In addition, I was unable to obtain sufficient, appropriate audit evidence that management had properly accounted for investment property disclosed in the statement of financial position and in note 3 to the financial statements due to inadequate record management. I was unable to confirm the balance of investment property by alternative means. Consequently, I was unable to determine whether any adjustment was necessary to investment property stated at R18,3 million in the financial statements.

## Bulk purchases

13. In terms of *GRAP 1, Presentation of Financial Statements*, an entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting. The municipality incorrectly recorded bulk purchases in relation to the prior financial year in the current financial period. Subsequently bulk purchases as disclosed in note 32 to the financial statements is overstated by R2,7 million (2014: R2,7 million) and payables from exchange transactions is understated by the same amount.

## General expenses

14. In terms of the *GRAP Framework*, information must represent faithfully the transactions and other events it purports to either represent, or could reasonably be expected to represent. The municipality did not;
- Accurately record all general expenses related to the financial year as supplier invoices did not agree to recorded values in the general ledger.
  - Recognise all general expenses relating to the financial year in the financial statements of the municipality.
15. Consequently, due to the lack of systems, it was impracticable to determine the full extent of the understatement of general expenses of R32,6 million (2014: R50,6 million) in note 33 to the financial statements and payables from exchange transactions.

## Cash flow statement

16. Supporting evidence for the cash flow statement, in both the current and corresponding financial years, was not available and no alternative audit procedures were possible. Consequently, I was unable to determine the value of adjustments required to the cash flows as disclosed in the cash flow statement and note 36 to the financial statements.

## Aggregation of immaterial uncorrected misstatements

17. The financial statements as a whole were materially misstated due to the cumulative effect of individually immaterial uncorrected misstatements making up the statement of financial position. Inventories as disclosed in note 8 to the financial statements was understated by R1,8 million.
18. In addition, I was unable to obtain sufficient, appropriate audit evidence regarding amounts disclosed for cash and cash equivalents of R805 740 included in the disclosed balance of R3,9 million as per note 11 to the financial statements. I was unable to confirm this item by alternative means. Consequently, I was unable to determine whether any adjustment to this item was necessary.

## Payables from exchange transactions

19. The corresponding figure for payables from exchange transactions and the related expenditure were overstated by R2 million as a result of the municipality not having adequate systems to identify and account for expenditure in accordance with *GRAP 1, Presentation of financial statements*.
20. Sufficient appropriate audit evidence could not be obtained due to poor record management for the items set out below:
  - Amounts due for third party payments
  - Salary suspense accounts
  - Unallocated deposits
  - A listing of creditors
  - Payments received in advance
21. I was unable to confirm this corresponding balance by alternative means. Consequently, I could not determine if any adjustments were necessary to the payables from exchange transactions, amounting to R76,3 million as disclosed in the statement of financial position and note 17 to the financial statements.
22. My audit opinion on the financial statements for the period ended 2013-14 was modified accordingly. My opinion on the current period's financial statements is also modified because of the possible effect of these matters on the comparability of the current period's figures.

## Repairs and maintenance

23. Sufficient appropriate audit evidence was not submitted to substantiate repairs and maintenance, in the corresponding figure, in the financial statements. I was unable to confirm this expenditure by alternative means. Consequently, I was unable to determine whether any adjustment was necessary to the repairs and maintenance expenditure of R7,9 million disclosed in the statement of financial performance and note 43 to the financial statements.
24. My audit opinion on the financial statements for the period ended 2013-14 was modified accordingly. My opinion on the current period's financial statements is also modified because of the possible effect of these matters on the comparability of the current period's figures.

## Aggregation of immaterial uncorrected misstatements in corresponding figures

25. The financial statements as a whole were materially misstated due to the cumulative effect of numerous individually immaterial uncorrected misstatements, in the corresponding figures, in the following elements making up the statement of financial position, the statement of financial performance and the notes to the financial statements:
- Revenue from exchange transactions was understated by R1,6 million.
  - Fair value adjustments was overstated by R1,2 million.
  - Cash and cash equivalents was overstated by R598 500.
  - VAT receivable was understated by R841 785.
  - Finance lease obligation was understated by R587 700.
  - Investment property was overstated by R632 590.
  - Receivables from exchange and non-exchange is overstated by R874 069.
26. My audit opinion on the financial statements for the period ended 2013-14 was modified accordingly. My opinion on the current period's financial statements is also modified because of the possible effect of these matters on the comparability of the current period's figures.

## Qualified opinion

27. In my opinion, except for the 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 Nkonkobe Local Municipality 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.

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## **Emphasis of matters**

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

## **Restatement of corresponding figures**

29. As disclosed in note 38 to the financial statements, the corresponding figures for 30 June 2014 have been restated as a result of errors discovered during 30 June 2015.

## **Material losses**

30. As disclosed in note 31 to the financial statements, material losses to the amount of R10,8 million were incurred as a result of a write off of trade debtors.

31. As disclosed in note 29 to the financial statements, material losses to the amount of R9,6 million were incurred as a result of an impairment of property, plant and equipment.

32. As disclosed in note 51 to the financial statements, material losses to the amount of R9,7 million was incurred as a result of electricity distribution losses. Further to this, the percentage disclosed for electricity losses is above the acceptable range.

## **Events after reporting date**

33. As disclosed in note 1.2 to the financial statements, the boundaries of Nkonkobe Local Municipality and Nxuba Local Municipality have been redefined. The two municipalities will be amalgamating after the local government elections. The official date of the amalgamation has not been published in the government gazette and the financial implications for Nkonkobe Local Municipality cannot be reliably estimated.

## **Unauthorised expenditure**

34. As disclosed in note 40 to the financial statements, unauthorised expenditure amounting to R35,9 million was incurred by the municipality during the year ended 30 June 2015. This was as a result of expenditure which was not adequately budgeted for and expenditure in excess of the budget.

## **Fruitless and wasteful expenditure**

35. As disclosed in note 40 to the financial statements, fruitless and wasteful expenditure of R1,1 million was incurred by the municipality during the year ended 30 June 2015. This was as a result of interest and penalties charged on late payments made by the municipality.

## **Additional matter**

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

## Unaudited disclosure notes

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

## Report on other legal and regulatory requirements

38. 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 development priorities 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

39. I performed procedures to obtain evidence about the usefulness and reliability of the reported performance information for the following selected development priority presented in the annual performance report of the municipality for the year ended 30 June 2015:
- Development objective 1: Basic Service Delivery
40. I evaluated the reported performance information against the overall criteria of usefulness and reliability.
41. 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. 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).
42. I assessed the reliability of the reported performance information to determine whether it was valid, accurate and complete.
43. The material findings in respect of the selected development priorities are as follows:

Development objective 1: Basic service delivery

Usefulness of reported performance information

Consistency of objectives

44. Section 41(c) of the Municipal Systems Act requires the service delivery agreement to form the basis for the annual report, therefore requiring consistency of objectives, indicators and targets between planning and reporting documents. Municipal Finance Management Act (MFMA) circular number 13 requires that the integrated development plan (IDP) and the service delivery budget implementation plan (SDBIP) must be consistent with the annual report.
45. One hundred percent of the reported development objectives were not consistent with the planned development objectives. This was due to management not agreeing the planned objectives as per the approved IDP to the SDBIP.

### **Additional matter**

46. I draw attention to the following matter:

Achievement of planned targets

47. Refer to the annual performance report on page x to x for information on the achievement of the planned targets for the year.

### **Compliance with legislation**

48. 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:

### **Financial statements, performance and annual reports**

49. 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 identified by the auditors in the submitted financial statements were not adequately corrected and the supporting records could not be provided subsequently, which resulted in the financial statements receiving a qualified audit opinion.

### **Audit committees**

50. 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.



51. The audit committee did not advise the council and the accounting officer on matters relating to the adequacy, reliability and accuracy of financial reporting and information, as required by section 166(2)(a)(iv) of the MFMA.
52. The audit committee did not advise the council and the accounting officer on matters relating to compliance with legislation, as required by section 166(2)(a)(vii) of the MFMA.
53. The audit committee did not respond to the council on the issues raised in the audit reports of the Auditor-General, as required by section 166(2)(c) of the MFMA.
54. The performance audit committee or audit committee did not review the municipality's performance management system and/or make recommendations to the council, as required by MPPMR 14(4)(a)(ii).
55. The performance audit committee or audit committee did not review all the quarterly internal audit reports on performance measurement, as required by MPPMR 14(4)(a)(i).
56. The performance audit committee or 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 MPPMR 14(4)(a)(iii).
57. The audit committee did not meet at least four times a year, as required by section 166(4)(b) of the MFMA.
58. The performance audit committee did not meet at least twice during the financial year, as required by MPPMR 14(3)(a).

## **Internal audit**

59. 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 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.

## **Procurement and contract management**

60. Sufficient appropriate audit evidence could not be obtained that all contracts were awarded in accordance with the legislative requirements and a procurement process which is fair, equitable, transparent and competitive, as sufficient supporting documentation was not submitted for audit.
61. Sufficient appropriate audit evidence could not be obtained that invitations for competitive bidding were advertised for a required minimum period of days, as required by SCM regulation 22(1) and 22(2).
62. Contracts were awarded to bidders based on points given for criteria that differed from those stipulated in the original invitation for bidding, in contravention of SCM Regulations 21(b) and 28(1)(a) and the Preferential Procurement Regulations.
63. Bid adjudication was not always done by committees which were composed in accordance with SCM regulation 29(2).

64. Sufficient appropriate audit evidence could not be obtained that the preference point system was applied in all procurement of goods and services above R30 000 as required by section 2(a) of the Preferential Procurement Policy Framework Act and SCM regulation 28(1)(a).
65. Contracts and quotations 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 and its regulations.
66. Sufficient appropriate audit evidence could not be obtained that contracts were awarded to bidders that scored the highest points in the evaluation process, as required by of section 2(1)(f) of Preferential Procurement Policy Framework Act.
67. 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).
68. Awards were made to providers who are in the service of other state institutions or whose directors are in the service of other state institutions, in contravention of MFMA 112(j) and SCM regulations 44. Similar awards were identified in the prior year and no effective steps were taken to prevent or combat the abuse of the SCM process in accordance with SCM regulation 38(1).
69. 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.
70. 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.

## **Human resource management and compensation**

71. An acting municipal manager was appointed for a period of more than three months without the approval by the MEC and for more than six months in contravention of section 54A(2A) of the Municipal Systems Act.

## **Expenditure management**

72. Reasonable steps were not taken to prevent unauthorised, irregular and fruitless and wasteful expenditure, as required by section 62(1)(d) of the MFMA.
73. Money owed by the municipality was not always paid within 30 days, as required by section 65(2)(e) of the MFMA.

## **Asset management**

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

## **Liability management**

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

## **Consequence management**

76. 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.
77. Allegations of financial misconduct against senior managers were not always tabled before council, as required by disciplinary regulations for senior managers 5(2).

## **Strategic and performance management**

78. The performance management system and related controls were inadequate as it did not describe and represent the processes of performance planning, monitoring, measurement, review, reporting, improvement and how it is conducted, organised and managed, including determining the roles of the different role-players, as required by section 38 of the MSA and regulation 7 of the MPPMR.

## **Internal control**

79. I considered internal control relevant to my audit of the 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 compliance with legislation included in this report.

## **Leadership**

80. Slow response to audit messages and effective leadership remain a challenge. The roles and responsibilities for recording and filing financial and performance information have been communicated to all relevant staff, but there is a lack of effective oversight by all leadership and oversight structures to ensure accountability and adequate consequences for poor performance and transgressions, which resulted in repeat financial, performance information and compliance findings raised during the audit.
81. Oversight responsibilities regarding the monitoring of internal controls over financial reporting and compliance with applicable laws and regulations were not adequately performed. This resulted in the qualified audit opinion, non-compliance with applicable laws and regulations and the information presented in the report on predetermined objectives not being useful.
82. The leadership did not implement adequate controls to ensure that the financial statements submitted for auditing did not contain material errors and non-compliance with applicable legislation. The audit action plan was not adequately monitored by the leadership to ensure that management addressed internal control deficiencies.

## Financial and performance management

83. The financial statements were subject to material adjustments that were not detected by management. In addition, there were material misstatements that were not corrected and form the basis of the qualified audit opinion. This is due to adequate daily and monthly financial processing and reconciliations not always taking place prior to the preparation of the financial statements, and the audit process was utilised to correct the financial records.
84. The municipality did not have a proper system of record management that provided for the maintenance of information to be reported in the annual performance report. This includes information that relates to the collection, collation, verification, storing and reporting of actual performance information.
85. The municipality's compliance monitoring process was not effective in the implementation and monitoring of controls to ensure that non-compliance with its laws and regulations was prevented or detected. This contributed to repeat non-compliance findings in the current year.

## Governance

86. The recommendations of the internal audit unit were not adequately addressed by management and therefore did not have a positive impact on addressing control deficiencies that existed in the municipality's control environment.
87. The audit committee was not effective in strengthening the control environment within the municipality, as numerous material misstatements were identified during the audit. Furthermore, recurring findings on financial reporting, performance reporting and compliance matters were identified during the audit process.

East London

30 November 2015



AUDITOR - GENERAL  
SOUTH AFRICA

*Auditing to build public confidence*

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