

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 2016, 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 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, 2015 (Act No. 1 of 2015) (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 56 to the consolidated financial statements at R235 million (2014-15: R554 million) was understated by at least R227 million as a result of the inappropriate application of S36 of the Supply Chain Management (SCM) Regulations. This was due to an inadequate system in place for the management of contracts. As a result the municipality had insufficient time to follow the normal procurement processes which resulted in a significant increase in the use of deviations. 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.

Aggregation of immaterial uncorrected misstatements

7. The consolidated financial statements are materially misstated due to the cumulative effect of individually immaterial uncorrected misstatements in the following items making up the total assets to the consolidated financial statements:
 - I was unable to obtain sufficient appropriate audit evidence for work in progress (WIP) included in property, plant and equipment (PPE) disclosed in the consolidated financial statements or confirm by alternative means that invoices for infrastructure were actually received due to the inadequate asset management system in place. Consequently I was unable to determine whether adjustments were necessary for the amount of R33 million to the PPE (WIP) as stated in note 4 of the consolidated financial statements.
 - Consumer Debtors included in the receivables from exchange transaction in the consolidated financial statements are overstated by R31 million due to inadequate internal control systems to record and collect revenue from billing.

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 2016 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. Cumulative debt impairment provisions of R1,1 billion (2015: R899,8 million) are disclosed in note 12 and 14 to the consolidated financial statements.

11. As disclosed in the statement of financial performance and note 39 to the consolidated financial statements, debt impairments totalling R210,1 million (2015: R365,1 million) have been expensed.

Material losses

12. The municipality incurred material losses as disclosed in note 58 to the consolidated financial statements. These include the following:
- Electricity losses totalling R180,5 million (2015: R162,8 million) of which non-technical losses comprise R99,7 million (2015: R95,1 million).
 - Water losses totalling R116,7 million (2015: R99,3 million) of which non-technical losses comprise R31,3 million (2015: R12,8 million)

Unauthorised expenditure

13. As disclosed in note 54 to the consolidated financial statements, unauthorised expenditure of R22 million (2015: R432,1 million) was incurred as a result of overspending on debt impairment, depreciation and asset impairments, finance charges, transfers and grants due to an increase in indigents, and transfers between operating and capital expenditure.

Fruitless and wasteful expenditure

14. As disclosed in note 55 to the consolidated financial statements, fruitless and wasteful expenditure of R5,2 million (2015: R5,1 million) has accumulated over the last six years and has not been recovered or written off.

Restatement of corresponding figures

15. As disclosed in note 50 to the consolidated financial statements, the corresponding figures for 30 June 2015 have been restated as a result of errors discovered during the year ended 30 June 2016 in the consolidated financial statements of the municipality at, and for the year ended, 30 June 2015.

Additional matters

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.

Unaudited supplementary information

18. The supplementary information set out on pages XX to XX does not form part of the consolidated financial statements and is presented as additional information. We have not audited these schedules and, accordingly, we do not express an opinion thereon.

Report on other legal and regulatory requirements

19. 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

20. 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 2016.

21. I evaluated the reported performance information against the overall criteria of usefulness and reliability.

22. 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 (FMPP)*.

23. I assessed the reliability of the reported performance information to determine whether it was valid, accurate and complete.

24. 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*.

25. 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

26. The FMPPPI requires auditees to have appropriate systems to collect, collate, verify and store performance information to ensure reliable reporting of actual achievements against planned objectives, indicators and targets. For important indicators, the reported achievements against planned targets were not reliable because we were unable to obtain sufficient appropriate audit evidence for these targets. In addition, the reported achievements against planned targets for important indicators were not reliable when compared to the evidence provided.

Additional matters

27. I draw attention to the following matters:

Achievement of planned targets

28. 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 27 of this report.

Unaudited supplementary schedules

29. 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

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 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:

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 consolidated statement of financial position, financial performance and disclosure items identified by the auditors in the submitted consolidated financial statements were not adequately corrected and the supporting records could not be subsequently provided, which resulted in the consolidated financial statements receiving a qualified audit opinion.

Procurement and contract management

32. Goods and services with a transaction value of below R200 000 were procured without obtaining the required price quotations, in contravention of by supply chain management (SCM) regulation 17(a) and (c).
33. Goods and services of a transaction value above R200 000 were procured without inviting competitive bids, as required by SCM regulation 19(a). Deviations were approved by the accounting officer even though it was not impractical to invite competitive bids, in contravention of SCM regulation 36(1).
34. 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 5 of 2000 and its regulations.
35. Awards were made to providers who were in the service of other state institutions or whose directors were in the service of other state institutions, in contravention of MFMA 112(j) and SCM regulation 44. Similar awards were identified in the previous year and no effective steps were taken to prevent or combat the abuse of the SCM process, as required by SCM regulation 38(1).
36. Persons in 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, in contravention of SCM regulation 46(2)(e) and the code of conduct for councillors issued in terms of the Municipal Systems Act 32 of 2000 and the code of conduct for staff members issued in terms of the Municipal Systems Act.

Expenditure management

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

Revenue Management

38. Interest was not charged on all accounts in arrears, as required by section 64(2) (g) of the MFMA.

Asset management

39. An effective system of internal control for assets (including a complete and accurate asset register) was not in place, as required by section 63(2)(c) of the MFMA.

Consequence management

40. Irregular and 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)(b) of the MFMA.

Internal control

41. 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 the qualified opinion, the findings on the annual performance report and the findings on compliance with legislation included in this report.

Leadership

42. Instability and change in leadership during the year under review have perpetuated a lack of leadership disciplines to enable oversight and monitoring that promote efficiency and effectiveness in financial management, performance reporting and compliance with laws and regulations. This has not set the correct tone for building a high performance environment that promotes accountability.
43. Commitments made by leadership to fill critical senior and middle management positions were not met. Inadequate planning within the various directorates' coupled with 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 is not adequately implemented and monitored and, where necessary, consequence management is not always applied.

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 all areas of non-compliance during the year.

Governance

47. A risk assessment was conducted by the municipality, however risks identified within this assessment were not appropriately mitigated by the control environment.
48. The internal control deficiencies identified by internal audit and recommendations made by both internal audit and the audit committee were not adequately addressed by management. This had an impact on the effectiveness of these parties in executing their responsibilities.

Other reports

Investigations

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

- The State President signed a proclamation subsequent to financial year to institute an investigation into the supply chain management unit of the municipality by the Special Investigations Unit (SIU). The investigation is currently in progress.
- 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 the state funeral procurement.

Auditor-General

East London

15 December 2016



AUDITOR-GENERAL
SOUTH AFRICA

Auditing to build public confidence