



AUDITOR-GENERAL
SOUTH AFRICA

Auditing to build public confidence

Lukhanji Municipality

Audit Report

For the year ended 30 June 2016

Report of the auditor-general to the Eastern Cape provincial legislature and the council on Lukhanji Local Municipality

Report on the financial statements

Introduction

1. I have audited the financial statements of the Lukhanji Local Municipality set out on pages ... to ..., which comprise the statement of financial position as at 30 June 2016, the statement of financial performance, statement of changes in net assets, cash flow statement and the statement of comparison of budget information with actual information 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. 1 of 2015) (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 entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by

management, as well as evaluating the overall presentation of the financial statements.

5. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my qualified audit opinion.

Basis for qualified opinion

Investment property

6. The municipality did not account for its investment properties in accordance with *GRAP 16 Investment property* as a result of the following:
 - Properties that the municipality does not have control of were recorded in the register.
 - The municipality did not record all of its properties in the register.
7. Consequently, investment property as disclosed in note 7 is overstated by R142,8 million (2015: R142,8 million) and accumulated surplus as disclosed in the statement of financial position is overstated by R142,8 million (2015: R142,8 million).

Irregular expenditure

8. Irregular expenditure of R282,5 million (2015: R242,3 million) is disclosed in note 49. The municipality's processes for the recording and recognition of irregular expenditure were insufficient as amounts either did not agree to supporting documentation or were not recorded. Consequently, irregular expenditure is understated by R12,3 million (2015: R10,4 million).
9. In addition I was unable to obtain sufficient appropriate audit evidence for the restated 2015 opening balance of irregular expenditure disclosed at R175,5 million in note 49 as I was not provided with appropriate documentation to substantiate the amount disclosed. I was unable to confirm the amount of irregular expenditure by alternative means. Since this figure impacts on the balance of irregular expenditure disclosed in both the current and prior period, I was unable to determine whether any further adjustments were necessary to irregular expenditure of R271 million (2015: R242,3 million) as disclosed in note 49 to the financial statements.

Unauthorised expenditure

10. Unauthorised expenditure of R136,3 million is disclosed in note 47. The municipality's processes for the recording and recognition of unauthorised expenditure were insufficient as this was incorrectly calculated. Consequently, unauthorised expenditure is understated by R37,1 million (2015: R6,1 million).
11. I was unable to obtain sufficient appropriate audit evidence for the opening balance of the prior year and corresponding amount for unauthorised expenditure of R112,8 million and R23,6 million as management does not have appropriate systems to identify this expenditure.

12. I was unable to obtain the required evidence through alternative means. Consequently, I was unable to determine whether any adjustments to corresponding amount for unauthorised expenditure of R112,8 million as disclosed in note 47 to the financial statements were necessary.

Receivables from non-exchange transactions

13. I was unable to obtain sufficient appropriate audit evidence for the corresponding amount for receivables from non-exchange transactions of R25,2 million as disclosed in note 3 as I was not provided with appropriate documentation to substantiate the adjustment made to this figure and I could not confirm the amount by alternative means, as a result I could not determine whether adjustments were required to the corresponding figures.

Cash flow statement

14. The entity did not prepare the statement of cash flows in accordance with GRAP 2: Cash flow statements. As a result, the net cash flows from investing activities were overstated by R34, 7million

Qualified opinion

15. 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 Lukhanji Local Municipality 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

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

Restatement of corresponding figures

17. As disclosed in the statement of changes in net assets and note 43, the corresponding figures have been restated as a result of errors only corrected during the year ended 30 June 2016 that existed in the financial statements at, and for the year ended 30 June 2015.

Material impairments

18. As disclosed in note 2 and 3 to the financial statements, an amount of R229,1 million for receivables from exchange transactions and R108,2 million for receivables from non-exchange transactions (2015: R222,7 million and R75 million) has been impaired as a result of non-payment of consumer debtor accounts.

Material losses

19. As disclosed in note 50 to the financial statements, material losses on electricity distribution of R57,8 million were incurred due to environmental and technical factors as well as illegal connections.

Additional matter

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

Unaudited disclosure note

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

Report on other legal and regulatory requirements

22. In accordance with the Public Audit Act of South Africa, 2004 (Act No. 25 of 2004) and the general notice issued in terms thereof, I have a responsibility to report findings on the reported performance information against predetermined objectives of 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

23. I performed procedures to obtain evidence about the usefulness and reliability of the reported performance information of the following selected development priorities presented in the annual performance report of the municipality for the year ended 30 June 2016:
- Development priority: basic services and infrastructure development on pages x to x
 - Development priority: local economic development on pages x to x
24. 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).
25. I assessed the reliability of the reported performance information to determine whether it

was valid, accurate and complete.

26. The material findings in respect of the selected development priorities are as follows:

Basic services and infrastructure development

Usefulness of reported performance information

27. Section 41(c) of the Municipal Systems Act, 2000 (Act No. 32 of 2000) (MSA) requires actual achievements against all planned indicators and targets to be reported annually. The annual performance report submitted for audit purposes did not include the actual performance of 92% of all planned objectives specified in the integrated development plan (IDP) and 34% of all planned targets specified in the service delivery implementation plan (SDBIP) for the year under review. This was due to a lack of information systems recording and documenting actual achievements against targets and a lack of review of the completeness of reporting documents by management and the internal audit unit.
28. The FMPPI requires that performance targets must be specific in clearly identifying the nature and required level of performance and must be measurable. It also requires that performance indicators must be well defined by having clear data definitions so that data can be collected consistently and is easy to understand and use and that performance indicators must be verifiable.
29. The measurability of planned targets and indicators could not be assessed due to a lack of technical indicator descriptions and proper systems and processes and formal standard operating procedures or documented system descriptions. A total of 60% of the significantly important indicators/measures in relation to the overall mandate of the municipality were not well defined while 56% of the targets were not verifiable.

Reliability of reported performance information

30. 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. I was unable to obtain the information and explanations I considered necessary to satisfy myself as to the reliability of the reported performance information. This was due to limitations placed on the scope of our work due to the fact that the auditee could not provide sufficient appropriate evidence in support of the reported performance information and the auditee's records not permitting the application of alternative audit procedures.

Local economic development

Usefulness of reported performance information

31. Section 41(c) of the MSA requires actual achievements against all planned indicators and targets to be reported annually. The annual performance report submitted for audit purposes did not include the actual performance of 100% of all planned objectives specified in the integrated development plan (IDP) and 54% of all planned targets specified in the service delivery implementation plan (SDBIP) for the year under review. This was due to a lack of information systems recording and documenting actual achievements against targets and a lack of review of the completeness of reporting documents by management and the internal audit unit.
32. Performance targets should be specific in clearly identifying the nature and required level of performance as required by the FMPPI. A total of 23% of the targets were not specific.
33. Performance targets should be measurable as required by the FMPPI. I could not measure the required performance for 23% of the targets.
34. Performance indicators should be well defined by having clear definitions so that data can be collected consistently and is easy to understand and use, as required by the FMPPI. A total of 25% of the indicators were not well defined.
35. The processes and systems that produced the indicator should be verifiable, as required by the FMPPI. A total of 25% of the indicators were not verifiable.
36. This was because management did not adhere to the requirements of the FMPPI due to a lack of proper systems and processes and technical indicator descriptions.

Reliability of reported performance information

37. 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. The reported performance information was not valid, accurate and complete 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, monitoring of the completeness of source documentation in support of actual achievements and frequent review of the validity of reported achievements against source documentation.

Additional matter

38. I draw attention to the following matter:

Achievement of planned targets

39. Refer to the annual performance report on pages x to x; x to x for information on the

achievement of the 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 in paragraphs 27 to 37 of this report.

Compliance with legislation

40. 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:

Expenditure management

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

Revenue management

43. An adequate management, accounting and information system which accounts for revenue and debtors was not in place, as required by section 64(2)(e) of the MFMA.
44. An effective system of internal control for debtors and revenue was not in place, as required by section 64(2)(f) of the MFMA.

Asset management

45. 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.

Consequence Management

46. Unauthorised, Irregular, 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) and (b) of the MFMA.

Conditional grants

47. The municipality did not evaluate its performance in respect of programmes funded by the Municipal Infrastructure Grant allocation, as required by section 12(5) of the DORA.
48. The municipality did not evaluate its performance in respect of programmes or functions funded by the Municipal Systems Improvement Grant, INEG and Expanded Public Works Programme allocation, as required by section 12(5) of the DORA.

Procurement and contract management

49. Bids were not always evaluated by bid evaluation committees which were composed of officials from the departments requiring the goods or services, as required by SCM regulation 28(2).
50. Thresholds for local content on designated sectors' procurement were not properly applied in accordance with the requirements of preferential procurement regulation 9.

Annual financial statements, performance and annual reports

51. The financial statements submitted for auditing were not prepared in all material respects in accordance with the requirements of section 122 of the MFMA.
52. 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.
53. The 2014/15 annual report was not published for the local community to submit representations in connection with the annual report, as required by section 127(5)(a) of the MFMA.
54. The council failed to adopt an oversight report containing the council's comments on the annual report within the prescribed timelines, as required by section 129(1) of the MFMA.
55. The oversight report adopted by the council on the 2014/15 annual report was not made public, as required by section 129(3) of the MFMA.
56. The annual performance report for the year under review did not include
 - the performance of each external service provider of the municipality,
 - a comparison of the performance with set targets and a comparison with the previous financial year and
 - measures taken to improve performance, as required by section 46 (1)(a), (b) and (c) of the MSA.

Strategic and performance management

57. 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 Municipal planning and performance management regulation 3 and 11.
58. The amendment(s) to the integrated development plan(IDP) was not adopted by the council only after consultation with the district and taking into account all comments received as required by Municipal planning and performance management regulation 3 (4),(5) or (6).
59. Key performance 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 Municipal planning and performance management regulation 1 and 9(1)(a).

60. The KPIs set by the municipality did not include indicators on percentage of households with access to basic level of electricity and solid waste removal were not set by the municipality as required by section 43(2) of the MSA and the Municipal planning and performance management regulation 10(a).

Internal control

61. 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

62. Leadership did not sufficiently fulfil its oversight responsibilities with regards to the implementation and monitoring of internal controls and compliance with laws and regulations and did not insist on daily disciplines to ensure sound financial and performance management and compliance with laws and regulations.

Financial and performance management

63. The municipality's system of internal control did not identify the numerous misstatements within the financial statements. The control environment at the municipality is not fully functional, with inadequate daily, monthly processing and reconciliation of transactions expenditure, employee costs and non-current assets. In addition, management relied on consultants to compile the financial statements at year-end; however the underlying records had various deficiencies.
64. The annual performance reports also included material misstatements due to the lack of oversight of the collection, collation and reporting of performance information. There is limited assurance and accountability over the performance management system.
65. Leadership did not institute processes to monitor and review compliance with legislation. As a result numerous compliance findings has been reported which could have been prevented. There was a lack of consequence management evidenced by the number of repeat findings and lack of action taken to address irregular, fruitless and wasteful expenditure.

Governance

66. Risk management activities were not sufficient as evidenced by the large number of repeat findings. The municipality also lacked effective risk monitoring processes in order to ensure risks identified are appropriately managed. The municipality however

developed and approved a risk management policy in the current year.

67. The internal audit function lacked sufficient capacity to function effectively and produce reports during the financial year. As a result the governance structures of the municipality were severely compromised.

Auditor-General

East London

30 November 2016



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