



## REPORT OF THE AUDITOR-GENERAL TO THE FREE STATE LEGISLATURE AND THE COUNCIL ON THE MALUTI-A-PHOFUNG LOCAL MUNICIPALITY

### REPORT ON THE CONSOLIDATED FINANCIAL STATEMENTS

#### Introduction

1. I was engaged to audit the accompanying consolidated and separate financial statements of Maluti-A-Phofung Local Municipality, which comprise the consolidated and separate statement of financial position as at 30 June 2011, the consolidated and separate statement of financial performance, the statement of changes in net assets and the cash flow statement for the year then ended, a summary of significant accounting policies and other explanatory information, as set out on pages [XX] to [XX].

#### Accounting officer's responsibility for the consolidated financial statements

2. The accounting officer is responsible for the preparation and fair presentation of these consolidated and separate financial statements in accordance with South African Standards of Generally Recognised Accounting Practice (SA Standards of GRAP) and in the manner required by the Local Government: Municipal Finance Management Act of South Africa, 2003 (Act No. 56 of 2003) (MFMA), and the Division of Revenue Act of South Africa, 2010 (Act No. 1 of 2010) (DoRA) and for such internal control as management determines 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. As required by section 188 of the Constitution of the Republic of South Africa, 1996 (Act No. 108 of 1996) and section 4 of the Public Audit Act of South Africa, 2004 (Act No. 25 of 2004) (PAA), my responsibility is to express an opinion on the consolidated and separate financial statements based on conducting the audit in accordance with the International Standards on Auditing and *General Notice 1111 of 2010* issued in *Government Gazette 33872 of 15 December 2010*. Because of the matters described in the basis for disclaimer of opinion paragraphs, however, I was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

#### Basis for disclaimer of opinion

##### Property, plant and equipment

4. I was unable to obtain sufficient appropriate audit evidence for property, plant and equipment of R865 227 476 and R862 826 195 (2010: R639 156 314 and R636 395 081) as disclosed in note 4 to the consolidated and separate financial statements. The municipality's records did not permit the application of alternative audit procedures. Consequently, I was unable to determine the existence, completeness, valuation and allocation of, as well as the municipality's rights to property, plant and equipment.
5. SA Standards of GRAP, GRAP 17, *Property, Plant and Equipment* paragraph 88 requires that the gross carrying amount of any fully depreciated property, plant and equipment that is still in use should be disclosed. Paragraphs 61 and 71 further require the municipality to review its assets' useful lives at least at each reporting date. The municipality did not comply with these requirements. Consequently, I could not obtain sufficient appropriate audit evidence to determine the valuation of property, plant and equipment and accumulated depreciation as

well as the accuracy of depreciation charges as disclosed in note 4 to the consolidated and separate financial statements for the current and prior year.

6. International Accounting Standards, IAS 36, *Impairment of cash-generating assets*, requires that property, plant and equipment be assessed for impairment at each reporting date. Management did not assess whether there had been a decrease in the value of property, plant and equipment during the financial year. Consequently, I could not obtain adequate audit assurance as to the valuation of the municipality's property, plant and equipment as disclosed in the consolidated and separate statement of financial position and note 4 to the consolidated and separate financial statements in the current and prior year.
7. I was unable to obtain sufficient appropriate audit evidence could for work in progress of R78 670 766 (2010: R149 472 751) as disclosed in note 4 to the consolidated and separate financial statements. The municipality's records did not permit the application of alternative audit procedures. Consequently, I was unable to obtain all the information and explanations I considered necessary to gain adequate audit assurance as to the valuation, existence and completeness of and rights to assets under construction.
8. I was unable to obtain sufficient appropriate audit evidence for the revaluation adjustment of R8 122 977 as disclosed in note 4 to the consolidated and separate financial statements. The municipality's records did not permit the application of alternative audit procedures. Consequently, I was unable to obtain all the information and explanations I considered necessary to gain adequate audit assurance as to the valuation and whether the adjustment should have been made in the prior year.
9. Included in other assets under property, plant and equipment as disclosed in note 4 to the consolidated and separate financial statements, are additions that relate to the previous financial year that were only recorded in the current financial year. Consequently, the opening balance for the current financial year and the additions and closing balance for the prior financial year are understated and the additions for the current financial year are overstated by R10 226 025.

#### **Investment property**

10. SA Standards of GRAP, GRAP 16, *Investment Property*, paragraph 5 requires an asset to be recognised as investment property when it is property held to earn rentals or for capital appreciation, or both. Paragraphs 2 and 18 further require a municipality to disclose investment property separately in the financial statements. Contrary to these requirements the municipality did not separately identify its investment property and the relevant disclosures were not made in note 4 to the separate and consolidated financial statements. Consequently, I was unable to satisfy myself as to the completeness, existence, valuation, allocation and compliance of investment property.

#### **Inventories**

11. SA Standards of GRAP, GRAP 12, *Inventories* paragraph 17 requires all inventories to be recognized at the lower of the cost of the inventories and the net realisable value. Paragraph 18 requires inventories to be shown at replacement value where it would be distributed at no or nominal cost or consumed in the production of goods distributed at no or a nominal cost. Contrary to these requirements I was unable to obtain sufficient appropriate audit evidence with regard to the valuation of consumable stores of R3 932 285, disclosed in note 9 to the consolidated financial statements. The municipality's records did not permit the application of alternative audit procedures.

## Trade and other receivables

12. Trade and other receivables from exchange transactions of R35 818 697 (2010: R75 489 706) disclosed in note 10 to the consolidated and separate financial statements include an unallocated deposit account of R17 878 322 (2010: R54 372 252). The entries in this account must be matched to the unidentified deposits that are disclosed under trade and other payables from exchange transactions in note 19 to the consolidated and separate financial statements as reported under trade and other payables from exchange transactions in this report. This was due to the suspense accounts not being cleared timeously and regularly. I was unable to obtain sufficient appropriate audit evidence regarding the existence, completeness, valuation and allocation and rights and obligations of unallocated deposits as disclosed in note 10 to the consolidated and separate financial statements. The municipality's systems did not allow me to perform alternative procedures.
13. I was unable to obtain sufficient appropriate audit evidence to determine the existence of consumer debtors of R16 853 618 included in consumer receivables of R152 808 604 and R153 215 311 respectively as disclosed in note 13 to the consolidated and separate financial statements. The municipality's records did not permit the application of alternative audit procedures.

## Value-added tax (VAT) receivable

14. I was unable to obtain sufficient appropriate audit evidence for the VAT receivable of R3 168 040 and R3 705 669 as disclosed in note 12 to the consolidated and separate financial statements. The municipality's records did not permit the application of alternative audit procedures. Consequently, I was unable to determine the existence, completeness, valuation and allocation of, and the municipality's right to the VAT receivable.

## Trade and other payables

15. I was unable to obtain sufficient appropriate audit evidence to determine the existence, completeness, valuation and allocation of, and the municipality's obligation towards unidentified deposits of R22 926 515 and R20 994 966 (2010: R58 265 884 and R57 998 689) and sundry payables of R3 077 222 (2010: R5 298 650) included in trade and other payables from exchange transactions of R242 124 146 and R188 743 925 (2010: R257 748 821 and R211 489 931) disclosed in note 19 to the consolidated and separate financial statements. The municipality's records did not permit the application of alternative audit procedures.
16. International Accounting Standards, IAS 39, *Financial Instruments: Recognition and Measurement*, paragraph 47 requires that after initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method. Contrary to this requirement, trade and other payables of R135 845 846 (2010: R68 585 270) included in note 19 to the consolidated and separate financial statements have not been recorded at amortised cost. Due to the lack of sufficient, appropriate audit evidence, I was unable to determine the valuation of trade payables.
17. I was unable to obtain sufficient appropriate audit evidence to determine the existence, completeness, valuation and allocation of, and the entity's obligation towards trade payables of R20 427 494 (2010: R17 713 433) disclosed in note 19 to the consolidated statement of financial position. The municipality's system did not permit the application of alternative audit procedures.

## Revenue

18. The calculation of property rates and service charges was incorrect as a result of incorrect tariffs and incorrect meter readings used in a number of instances. This resulted in an understatement of property rates by R2 117 964 (2010: R56 920 620) and service charges by R65 072 589. The service charges consist of understatements for sale of water by R3 370 478 (2010: R2 269 523), refuse removal by R12 631 676, sewerage and sanitation charges by R4 625 421 and sale of electricity by R44 445 014 (2010: R7 834 461) as disclosed in the

consolidated and separate statement of financial performance and notes 23 and 24 to the consolidated and separate financial statements. Trade receivables from exchange transactions as disclosed in the consolidated and separate statement of financial position is understated by the same amounts.

19. SA Standards of GRAP, GRAP 9, *Revenue* paragraph 20 states that when the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised with reference to the stage of completion of the transaction at the reporting date. The municipality recognised prepaid electricity sales when the sale took place and not over the expected period that the units sold would be utilised. Because the relevant information was not available I could not practicably determine the amount by which sale of electricity included in service charges of R218 535 551 and R222 289 096 as disclosed in the consolidated and separate statement of financial performance and note 24 to the consolidated and separate financial statements are overstated and trade and other payables from exchange transactions as disclosed in the consolidated and separate statement of financial position are understated.
20. I was unable to obtain sufficient appropriate audit evidence regarding the accuracy of meter-reading estimates at year-end. Due to the limitations involved, the financial impact thereof could not be practicably determined. The municipality's records did not permit the application of alternative audit procedures. Consequently, I could not satisfy myself as to the occurrence, accuracy and completeness of service charges of R218 535 551 and R222 289 096 as disclosed in the consolidated and separate statement of financial performance and note 24 to the consolidated and separate financial statements.
21. SA Standards of GRAP, GRAP 9, *Revenue*, paragraph 39 states that interest shall be recognised using the effective interest rate method. Interest received on consumer accounts as disclosed in note 60 to the consolidated and separate financial statements of R24 361 235 was understated by R14 770 845 and consumer debtors by the same. Since the municipality's accounting records did not permit the application of alternative audit procedures, I was unable to obtain all the information and explanations I considered necessary to gain adequate audit assurance as to the completeness and accuracy of interest received.
22. I was unable to obtain sufficient appropriate audit evidence regarding the completeness of sewerage charges of R34 260 928 and R24 759 134 included in service charges of R218 535 551 and R222 289 096 as disclosed in note 24 to the consolidated and separate financial statements respectively. The municipality's records did not permit the application of alternative audit procedures. Consequently, I could not satisfy myself as to the completeness of sewerage charges and the completeness and valuation of consumer receivables as disclosed in note 13 to the consolidated and separate financial statements.

## **Expenditure**

23. I was unable to obtain sufficient appropriate audit evidence to determine the occurrence, accuracy, cut-off and completeness of the community project expenditure of R33 679 072 disclosed in note 33 to the consolidated financial statements and the consolidated statement of financial performance. The municipality's records did not permit the application of alternative audit procedures.
24. I was unable to obtain sufficient appropriate audit evidence to determine the occurrence, accuracy, cut-off and completeness for general expenses of R14 530 835 included in the comparative figures for general expenses of R62 893 552 and R52 390 441 included in the consolidated and separate statement of financial performance. The municipality's system did not permit the performance of alternative audit procedures.
25. Included in the reversal of allowance for bad debt, as disclosed in note 58 to the consolidated and separate financial statements, is a debt impairment that relates to interdepartmental charges amounting to R28 849 436 which should have been reversed against service

charges. Consequently, impairment loss and service charges as disclosed in the statement of financial performance are overstated by this amount.

### **Capital commitments**

26. SA Standards of GRAP, GRAP 17, *Property, Plant and Equipment* paragraph 83(c) states that the financial statements shall disclose for each class of property, plant and equipment recognised in the financial statements the amount of contractual commitments for the acquisition of property, plant and equipment. Management did not maintain an updated contract register which provides particulars, including the committed amount, of all approved capital contracts, the expenditure incurred to date and the municipality's future capital commitments in respect of each contract in the current and previous year. The municipality's records did not permit the application of alternative audit procedures. Consequently, I could not obtain sufficient appropriate audit evidence to satisfy myself as to the completeness and valuation of capital commitments and I could not practicably quantify the resulting misstatement in the components of the consolidated and separate financial statements.

### **Irregular expenditure**

27. Irregular expenditure is defined in section 1 of the MFMA as expenditure incurred by the entity in contravention of or not in accordance with the MFMA, the Municipal Systems Act, 2000 (Act No. 32 of 2000), the Public Office-Bearers Act, 1998 (Act No. 20 of 1998) or a requirement of the supply chain management policy of the entity and must be disclosed in the financial statements in terms of section 125(d) of the MFMA.
28. I was unable to obtain sufficient appropriate audit evidence that expenditure of R23 664 988 were procured in accordance with legislative requirements and the SCM policy. The municipality's records did not permit the application of alternative audit procedures. Consequently, I was unable to confirm the completeness and valuation of irregular expenditure disclosed in note 51 to the separate and consolidated financial statements
29. The municipality did not disclose additional irregular expenditure of R39 103 269 and R35 955 984 (2010: R131 084 592), resulting from non-compliance with supply chain management (SCM) regulations, in the consolidated and separate financial statements respectively. The municipality's records did not permit the application of further alternative audit procedures. Consequently, I could not satisfy myself as to the completeness of irregular expenditure and I could not practicably quantify the resulting misstatement in note 51 to the consolidated and separate financial statements.

### **Unauthorised expenditure**

30. The approved budget for certain votes was exceeded by R165 162 000 (2010: R731 230) resulting in unauthorised expenditure as defined in section 1 of the MFMA. This was not disclosed in the consolidated and separate financial statements as required by section 125 of the MFMA, therefore unauthorised expenditure in the notes to the consolidated and separate financial statements is understated by this amount.

### **Fruitless and wasteful expenditure**

31. Fruitless and wasteful expenditure of R1 859 521 was incurred due to payments made to a service provider for services that were not rendered. This amount was not disclosed in note 50 of the annual financial statements. Consequently, fruitless and wasteful expenditure is understated by this amount.

### **Related parties**

32. I was unable to obtain sufficient appropriate audit evidence to determine the occurrence, accuracy and valuation, completeness, rights and obligations and classification and understandability of related parties as disclosed in note 45 to the financial statements. The municipality's system did not permit the application of alternative audit procedures.



### **Disclaimer of opinion paragraph**

33. Because of the significance of the matters described in the basis for disclaimer of opinion paragraphs, I have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, I do not express an opinion on the consolidated and separate financial statements.

### **EMPHASIS OF MATTER PARAGRAPH**

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

#### **Restatement of corresponding figures**

34. As disclosed in note 46 to the financial statements, the corresponding figures for 30 June 2010 have been restated as a result of an error discovered during the year ended 30 June 2011 in the financial statements of the Maluti-A-Phofung Local Municipality at, and for the year ended, 30 June 2010.

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

35. In accordance with the PAA and in terms of *General Notice 1111 of 2010*, issued in *Government Gazette 33872 of 15 December 2010*, I include below my findings on the annual performance report as set out on pages [XX] to [XX] and material non-compliance with laws and regulations applicable to the municipality.

#### **Presentation of information**

36. The reported performance against predetermined objectives was deficient in respect of the following criteria:
- Performance against predetermined objectives was not reported using the National Treasury guidelines.
37. The following audit findings relate to the above criteria:
- 37.1 Adequate explanations with regard to measures taken to improve performance were not provided as required in terms of section 46(1)(c) of the Municipal Systems Act (MSA) for any of the objectives reported.

#### **Reliability of information**

38. The reported performance information was deficient in respect of the following criteria:
- Validity: The reported performance did not occur and does not pertain to the entity.
  - Accuracy: The amounts, numbers and other data relating to reported actual performance have not been recorded and reported appropriately.
  - Completeness: All actual results and events that should have been recorded have not been included in the reported performance information.
39. The following audit findings relate to the above criteria:
- 39.1 The integrated development plan did not include the key performance indicators and performance targets determined in accordance with its performance management system, as required by sections 26(i) and 41(1) (b) of the MSA and regulation 12 of the Municipal Planning and Performance Management Regulations, 2001.

## **Compliance with laws and regulations**

### **Municipal Finance Management Act**

#### **Asset management**

- 40. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained a management, accounting and information system which accounts for the assets of the municipality as required by section 63(2)(a) of the MFMA.
- 41. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained an effective system of internal control for assets (including an asset register) as required by section 63(2)(c) of the MFMA.

#### **Procurement**

- 42. Invitations for competitive bidding were not always advertised for a required minimum period of days as per the requirements of SCM regulation 22(1) and 22(2). Furthermore, instances were noted where sufficient appropriate audit evidence could also not be obtained that invitations for competitive bidding were advertised for a required minimum period of days as per the requirements of SCM regulation 22(1) and 22(2).
- 43. Awards were made to suppliers based on preference points that were not calculated in accordance with the requirements of the Preferential Procurement Policy Framework Act and its regulations.

#### **Expenditure management**

- 44. The accounting officer did not take reasonable steps to prevent unauthorised expenditure and irregular expenditure, as required by section 62(1)(d) of the MFMA.
- 45. Payments to suppliers were not made within 30 days of date of receipt of the relevant invoice or statement, as prescribed by section 65(2)(e) of the MFMA.
- 46. The municipality did not recover unauthorised, irregular or fruitless and wasteful expenditure from the liable person, as required by section 32(2) of the MFMA.

#### **Budget**

- 47. The municipality incurred expenditure in excess of the limits provided for in the votes in the approved budget, in contravention of section 15 of the MFMA.

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

- 48. The financial statements submitted for audit did not comply with section 122 of the MFMA. Material misstatements were identified during the audit, some of which were corrected by management, while those that were not corrected are included in the basis for disclaimer of opinion paragraphs.
- 49. The annual performance report did not contain a comparison of the performance of the municipality and of each external service provider with development priorities, objectives and performance indicators set out in its integrated development plan as required by section 46 of the MSA.

#### **Revenue management**

- 50. The accounting officer did not take effective and appropriate steps to collect all money due to the municipality, as required in terms of section 38(c)(ii) of the MFMA.
- 51. Sufficient audit evidence could not be obtained that interest was charged on all arrears accounts, as required by section 64(2)(g) of the MFMA.

## **INTERNAL CONTROL**

52. I considered internal control relevant to my audit of the financial statements and the report on predetermined objectives and compliance with the MFMA, but not for the purpose of expressing an opinion on the effectiveness of internal control. The matters reported below are limited to the deficiencies identified during the audit.

### **Leadership**

53. Leadership lacked knowledge regarding the requirements for financial reporting. The reliance on an external consultant throughout the financial reporting process highlighted this weakness.
54. The SCM process was insufficiently aligned with the SCM regulations prescribed by the MFMA. On a number of matters, the SCM policy was less strict and this resulted in irregular expenditure and management not effectively detecting and preventing it.
55. There was also a lack of timeous action on the recommendations of external and internal audit which resulted in matters not being resolved. This includes the clearing of suspense accounts.
56. The lack of timeous performance reviews of managers did not support leadership's message of responsibility and performance.

### **Financial and performance management**

57. Finance staff lacks a general understanding of the GRAP accounting framework and as a result are not compiling regular, accurate and complete financial reports. The annual financial statements were subjected to material changes and were not properly reviewed.
58. There was an improvement in the safeguarding and provision of documentation, but the remaining deficiencies had a negative impact on the audit.
59. The lack of best practices in linking performance to supporting documentation and to link the performance measures to the IDP of the municipality hampered the performance reporting process.
60. The lack of implementation and monitoring of controls resulted in non-compliance with laws and regulations and in particular irregular and unauthorised expenditure.
61. The lack of knowledge and experience of personnel with regard to the matters listed above prevented the matters from being timeously detected and prevented.

### **Governance**

62. Ongoing monitoring of the effectiveness of internal audit was not undertaken as this would have highlighted the lack of management action on the recommendations made by internal audit with regard to the performance information. All internal audits as per the internal audit plan for the year under review could not be completed timeously due to inadequate staff in the internal audit unit.

## **OTHER REPORTS**

### **Investigations in progress**

63. In terms of *General Notice R40* published in *Government Gazette No. 30521 of 27 November 2007*, the President of South Africa requested an investigation by the Special Investigations Unit into several matters concerning the affairs of the municipality. As this investigation has not yet been finalised, it is not known what impact, if any, the matter under investigation could have on the financial transactions or whether it would result in the municipality suffering losses. This matter will be reported on once the investigation has been finalised.



64. The South African Police Service (SAPS) is also currently conducting an investigation, initiated in August 2008, into the alleged misappropriation of funds relating to services acquired by the municipality. As this investigation has not reached finality, it is not known what impact, if any, the matter under investigation could have on the financial transactions or whether it would result in the municipality suffering losses.
65. The SAPS is also currently conducting an investigation, into the internet transfer of funds from the municipality's bank account. The municipality suffered a loss of R822 637 and this investigation has not been finalised. It is not known what final impact, if any, the matter under investigation could have on the financial transactions or whether it would result in the municipality suffering further losses.

Auditor General

Bloemfontein

20 December 2011



AUDITOR-GENERAL  
SOUTH AFRICA

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