

REPORT OF THE AUDITOR-GENERAL TO THE WESTERN CAPE PROVINCIAL PARLIAMENT AND THE COUNCIL ON KANNALAND MUNICIPALITY

REPORT ON THE FINANCIAL STATEMENTS

Introduction

1. I was engaged to audit the accompanying financial statements of Kannaland Municipality, which comprise the statement of financial position as at 30 June 2011, and the statement of financial performance, statement of changes in net assets and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information, as set out on pages 3 to 69.

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 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 of South Africa, 2010 (Act No. 1 of 2010) (DoRA), and for such internal control as the accounting officer determines 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. As required by section 188 of the Constitution of the Republic of South Africa, 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 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 unable to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for disclaimer of opinion

Debt impairment

4. Standards of GRAP, GRAP 104, *Financial Instruments*, requires that the debt impairment expense be recognised exclusive of Value-Added Tax (VAT). The debt impairment expense includes VAT of R3 829 963. Consequently, the debt impairment expense is overstated by R3 829 963 and taxes are understated by the same amount.

Receivables from exchange transactions

5. Receivables from exchange transactions of R3 297 127, as disclosed in note 18 to the financial statements, are understated by R825 523 due to unreconciled differences between the monthly receivables from exchange transactions, statements issued and the balance recorded per the financial statements. Consequently, the receivables from exchange transactions and revenue from exchange transactions are understated by R825 523.

6. Included in receivables from exchange transactions of R3 297 127, as disclosed in note 18 to the financial statements, are credit balances amounting to R923 110 which should have been reclassified to payables from exchange transactions. Receivables from exchange transactions are understated by R923 110 while payables from exchange transactions are understated by the same amount.

Property, plant and equipment

7. Included in the carrying value of property, plant and equipment of R200 324 066, as disclosed in note 11 to the financial statements, are land and buildings which were incorrectly recorded at R6 493 142 more than the value reflected in the valuation roll. The municipality's records did not permit the application of alternative audit procedures regarding the valuation of the land and buildings. Consequently, the property, plant and equipment balance is overstated by R6 493 142 and the opening retained earnings understated by the same amount.

Inventory

8. Standards of GRAP, GRAP 12, *Inventory*, requires disclosure of information about the carrying amounts held in different classifications of inventory and the extent of the changes in these assets which is useful to financial statement users. The inventory balance of R1 061 260, as disclosed in note 17 to the financial statements, has been incorrectly classified as consumable stores. Had the inventory balance been correctly classified consumable stores of R741 431 and electricity of R319 829 would have been individually disclosed in note 17 to the financial statements.
9. Included in the inventory balance of R1 061 260, as disclosed in note 17 to the financial statements, is electricity on hand amounting to R319 829. The entity's records did not permit the application of alternative audit procedures regarding the occurrence and accuracy of electricity on hand. Consequently, I did not obtain sufficient appropriate audit evidence to satisfy myself as to the occurrence and accuracy of electricity inventory.
10. Included in consumable stores of R1 061 260, as disclosed in note 17 to the financial statements, is an amount of R741 431 for which an inventory listing and cut-off documentation could not be provided. The municipality's records did not permit the application of alternative audit procedures regarding inventory. Consequently, I was unable to satisfy myself as to the accuracy and occurrence of the inventory balance.

Payables from exchange transactions

11. Included in payables from exchange transactions of R11 832 814, as disclosed in note 8 to the financial statements, is an amount due to the South African Revenue Service for Value-Added Taxation (VAT) and Pay-As-You-Earn (PAYE) of R2 340 391. The balance for payables from exchange transactions, as disclosed in note 8 to the financial statements also includes an amount of R1 121 682 owed to the Compensation Commissioner for workmen's compensation. The municipality did not reconcile these balances and its records did not permit the application of alternative audit procedures regarding the amount payable to SARS and the Compensation Commissioner. Consequently, I did not obtain sufficient appropriate audit evidence to satisfy myself as to the accuracy and completeness of payables from exchange transactions.

Unspent conditional government grants and receipts

12. Included in unspent conditional government grants and receipts of R4 738 764, as disclosed in note 9 to the financial statements, is an amount of R800 472 for which the conditions attached to the grant have been fulfilled and for which a transfer should have been made to revenue in accordance with Standards of GRAP, GRAP 23, *Revenue from non exchange transactions*. Consequently unspent conditional government grants are overstated and revenue from non exchange transactions is understated. Had this been transferred to revenue from non exchange transactions, the net surplus would have increased by R800 472.

Rehabilitation provision

13. Standards of GRAP, GRAP 19, *Provisions, contingent liabilities and contingent assets*, requires a provision for the environmental rehabilitation costs of restoring the municipality's landfill sites to be recognised as a consequence of its past use of the landfill sites. The municipality has recognised an environmental provision of R4 593 800, as disclosed in note 4 to the financial statements. The municipality's records, however, did not permit the application of alternative audit procedures regarding an assessment for the reasonableness of assumptions made in computing the provision. Consequently, I was unable to satisfy myself as to the accuracy and valuation of the provision for rehabilitation of landfill sites.

Contingent liabilities

14. Confirmations from legal representatives have not been received. Consequently, I was unable to satisfy myself as to the completeness of provisions as disclosed in note 7 to the financial statements and contingent liabilities, as disclosed in note 48 to the financial statements at year end.

Revenue from exchange transactions

15. Included in the service charges revenue of R33 670 454, as disclosed in note 24 to the financial statements, is an amount of R7 143 531 charged to bulk consumers. As a result of the fire that destroyed the supply chain management office, I could not perform alternative audit procedures to confirm the accuracy and completeness of bulk sales revenue. Consequently, I was unable to obtain sufficient appropriate audit evidence to satisfy myself as the accuracy and completeness of service charges amounting to R7 143 531.
16. Included in service charges revenue of R33 670 454 as disclosed in note 24 to the financial statements, is revenue from the sale of electricity amounting to R1 768 752 which was incorrectly recognised in the 2010-11 financial year instead of the 2009-10 financial year. Had the service charges been recognised in the correct period services charges would have been reduced and opening retained earnings would have increased by R1 768 752.

Payroll

17. The employee-related costs, as disclosed in the statement of financial performance, do not agree to the general ledger balance by R847 762. Consequently, employee-related costs are overstated by R847 762. I was unable to determine the effect on the other account balances or classes of transactions contained in the financial statements.
18. The employee-related costs for the 2009-10 financial year, as disclosed in the statement of financial performance do not agree to the general ledger balance by R526 757.

Consequently, employee-related costs in the 2009-10 financial year are overstated by R526 757. I was unable to determine the effect on the other account balances or classes of transactions contained in the financial statements.

19. The remuneration of key management related costs balance of R3 165 548, as disclosed in note 26 to the financial statements, differ by R986 831 from the balance per the underlying accounting records). The entity did not reconcile the difference of R986 831 between the financial statements and the underlying accounting records. Consequently, remuneration of key management related costs are overstated by R986 831. I was unable to determine the effect on the other account balances or classes of transactions contained in the financial statements.
20. The remuneration of councillors costs balance of R2 847 555, as disclosed in note 27 to the financial statements, differ by R755 105 from the balance per the underlying accounting records. The entity did not reconcile the difference of R755 105 between the financial statements and the underlying accounting records. Consequently, remuneration of councillors is overstated by R755 105. I was unable to determine the effect on the other account balances or classes of transactions contained in the financial statements.
21. The remuneration paid to the full-time councillors was in excess of that applicable to grade 2 municipalities as stipulated in the Remuneration of Public Office Bearers Act, 1998 (Act No. 20 of 1998). The remuneration overpaid, therefore, constitutes irregular expenditure amounting to R155 366 and should have been disclosed as such in the financial statements in terms of section 125(2)(d) of the MFMA.

Restatement journals

22. I was unable to obtain sufficient appropriate supporting documentation regarding the restatement adjustments as disclosed in note 34 to the financial statements. Consequently, I was unable to obtain sufficient appropriate audit evidence considered necessary to satisfy myself as to the occurrence, accuracy completeness and compliance with the GRAP reporting framework of the restatement adjustments

Other compulsory disclosures

23. Municipal Supply Chain Management Regulations, 2005, regulation 36(2) stipulates that reasons for any deviations from the official procurement processes must be disclosed in a note to the annual financial statements. Payments amounting to R454 972 were identified to have been made in contravention of the requirements of the Municipal Supply Chain Management Regulations, 2005. The deviations were not disclosed in the notes to the financial statements, as required by the Municipal Supply Chain Management Regulations, 2005, resulting in the disclosure in the financial statements being incomplete.

Material losses

24. Section 125(2)(d) of the MFMA requires that the particulars of all material losses that occurred during the financial year be disclosed. As disclosed in note 40.4 to the financial statements the municipality was unable to determine the water losses for the financial year under review while no rand value for the electricity losses incurred was disclosed. The municipality's records did not permit the application of alternative audit procedures regarding the completeness of the disclosure for material losses. Consequently, I was unable to satisfy myself as to the accuracy of the material losses disclosure.

Material inconsistencies in the financial statements

25. The total net assets for the year as disclosed in the statement of changes in net assets is R486 306, whereas the correct amount is R160 345 758.
26. The purchase of investment property per the cash flow statement for the 2009-10 financial year of R667 806 does not agree to note 12 to the financial statements by R667 806, because the amount is not disclosed in note 12.
27. Grants and public contributions received per the cash flow statement for the 2009-10 financial year of R38 510 797 do not agree to note 23.8 to the financial statements by R3 588 649.
28. The purchases of property, plant and equipment per the cash flow statements of R10 815 997 (2009-10: R11 662 789) do not agree to note 11 to the financial statements by R612 249 (2009-10: R4 543 599).
29. Total rates receivables from non exchange transactions of R9 670 496 per note 19 to the financial statements, do not agree to the ageing in the same note by R656 223.
30. The 2009-10 unconditional grants, equitable share of R11 647 736 per note 23 to the financial statements, do not agree to the ageing in the same note by R451 399.
31. The restatement of opening balances per note 34 to the financial statements relating to intangibles and long-term liabilities in the financial statements, does not agree to the 2009-10 financial statements by R433 850 and R521 342, respectively.
32. The non-cash adjustment relating to contributions paid by employees of R1 432 082 (2009-10: R621 997) per note 35 to the financial statements, does not agree to note 3 to the financial statements by R1 157 462 (2009-10: R344 418).
33. The increase in trade and other receivables of R5 825 582 per note 35 to the financial statements, does not agree to the movement per the statement of financial position by R5 265 675.
34. The total financial assets per note 44.1 to the financial statements, does not cast by R3 124 341 (2009-10: R2 749 438).

Disclaimer of opinion

35. 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 financial statements.

Emphasis of matters

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

Restatement of corresponding figures

37. As disclosed in note 34 to the financial statements, the corresponding figures for 30 June 2010 have been restated as a result of errors discovered during the 2010-11 financial year in the financial statements of Kannaland municipality at, and for the year ended, 30 June 2010.

Material losses

38. As disclosed in note 40.4 to the financial statements, the municipality incurred an electricity loss of 19% or 7 456 255 kilowatts during the year under review. As reported in paragraph 24 of the audit report, the rand value of the loss could not be determined due to a lack of supporting information.

Material underspending

39. As disclosed in note 39.3 to the financial statements, the municipality had materially underspent its capital budget by R7 341 349. As a consequence, the municipality has not completed its planned capital projects relating to community and social services, housing and electricity.

Funding of operations

40. The balance for unspent conditional government grants and receipts of R4 738 764, as disclosed in note 9 to the financial statements includes unspent conditional government grants and receipts of R1 551 273, which are not cash backed as required by accounting policy note 1.9.

Additional matter

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

Material inconsistencies in other information included in the annual report

42. The draft annual report has not been received for review. As a result, it has not been reviewed for any inconsistencies with the financial statements. The draft annual report as well as the final printer's proof of the annual report will be reviewed and any material inconsistencies then identified will be communicated to management. Should the inconsistencies not be corrected, it may result in the matter being included in the audit report.

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

43. 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 and material non-compliance with laws and regulations applicable to the municipality.

Predetermined objectives

44. I was unable to conduct the audit of performance against predetermined objectives as the municipality did not submit the annual performance report required by section 46 of the Local Government: Municipal Systems Act of South Africa, 2000 (Act No. 32 of 2000) (MSA) and section 121(3)(c) of the MFMA.

Compliance with laws and regulations

Financial statements and annual report

45. The accounting officer did not submit the annual financial statements of the municipality for auditing, within two months after the end of the financial year as required by section 126(1)(a) of the MFMA.

Strategic planning and performance management

46. The municipality did not implement a framework that describes and represents how the municipality's cycle and processes of performance planning, monitoring, measurement, review, reporting and improvement will be conducted, organised and managed, including determining the roles of the different role players, as required by sections 38, 39, 40 and 41 of the MSA read with regulations 7 and 8 of the Municipal Planning and Performance Management Regulations, 2001.

Internal audit

47. The internal audit unit did not function, as required by section 165(2) of the MFMA in that:
- Internal audit did not advise the accounting officer and report on matters relating to accounting procedures and practices.
 - Internal audit did not report on matters relating to compliance with the MFMA, the DoRA and other applicable legislation as required by section 165(2)(b) of the MFMA.

Audit committee

48. The audit committee did not advise the municipal council, the political office bearers, the accounting officer and the management staff of the municipality on matters relating to compliance with the MFMA, the DoRA and other applicable legislation as required by section 166(2)(a) of the MFMA.

Budget

49. The municipality incurred expenditure that was not budgeted for and incurred expenditure in excess of the limits of the amounts provided for in the votes in the approved budget, in contravention of section 15 of the MFMA.
50. The mayor did not submit all quarterly reports to council on the implementation of the budget and the financial state of affairs of the municipality within 30 days after the end of each quarter, as required by section 52(d) of the MFMA.
51. The accounting officer did not always submit the monthly budget statements to the mayor and/or the relevant provincial treasury, as required by section 71(1) of the MFMA.
52. Unforeseeable and/or unavoidable expenditure not provided for in the annual budget was incurred, but was then not appropriated in an adjustment budget, as required by section 29(2)(d) of the MFMA.

Expenditure management

53. Money owing by the municipality was not always paid within 30 days of receiving an invoice or statement, as required by section 65(2)(e) of the MFMA.
54. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained an effective system of expenditure control, including procedures for the approval, authorisation, withdrawal and payment of funds, as required by section 65(2)(a) of the MFMA.
55. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained a management, accounting and information system which recognised expenditure when it was incurred, accounted for creditors of the municipality and accounted for payments made by the municipality, as required by section 65(2)(b) of the MFMA.
56. The accounting officer did not take reasonable steps to prevent unauthorised, irregular expenditure and fruitless and wasteful expenditure, as required by section 62(1)(d) of the MFMA.

Transfer and conditional grant

57. Sufficient appropriate audit evidence could not be obtained that the allocations for conditional grants were utilised for the purposes stipulated in their respective schedules or gazetted Division of Revenue Act framework, as required by section 15(1) of the DoRA.
58. Sufficient appropriate audit evidence could not be obtained that the municipality always submitted monthly reports to the transferring national officer, the National Treasury and/or the Provincial Treasury on spending and financial performance in respect of the allocations received, as required by section 11(2)(b) of the DoRA and section 71(5) of the MFMA and on non-financial performance in respect of the allocation received as required by section 11(2)(c) of the DoRA.
59. Sufficient appropriate audit evidence could not be obtained that the accounting officer evaluated the performance of the municipality in respect of programmes funded or partially funded by a schedule 4 allocation within two months after the end of the financial year as

required by section 11(6) of the DoRA.

Procurement and contract management

60. Sufficient appropriate audit evidence could not be obtained that contracts to the value of R13 809 916 were procured in accordance with the requirements of chapter 11 of the MFMA and the Municipal Supply Chain Management Regulations, 2005 due to a fire destroying the municipality's supply chain management documentation in August 2011.
61. Included in the carrying value of property, plant and equipment of R200 324 066, as disclosed in note 11 to the financial statements, are additions amounting to R6 967 628 for which no supporting documentation could be provided to obtain sufficient appropriate audit evidence necessary to satisfy myself as to the compliance with the requirements of Chapter 11 of the MFMA and the Municipal Supply Chain Management Regulations, 2005. The municipality's records did not permit the application of alternative audit procedures. Consequently, I did not obtain sufficient appropriate audit evidence to satisfy myself as to the compliance pertaining to property, plant and equipment additions.

Asset management

62. 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.

Human resources management

63. Senior managers directly accountable to the municipal manager did not sign annual performance agreements for the year under review, as required by sections 57(1)(b) and 57(2)(a) of the MSA.
64. The municipal manager did not provide job descriptions for each post in the staff establishment as required by section 66(1)(b) of the MSA.
65. The municipality could not provide evidence that managers directly accountable to the municipal manager were appointed with approval by the council, as required by section 56(a) of the MSA.
66. The municipal manager did not sign an annual performance agreement for the year under review, as required by sections 57(1)(b) and 57(2)(a) of the MSA.

Revenue management

67. Sufficient audit evidence could not be obtained that interest was charged on all arrear accounts, as required by section 64(2)(g) of the MFMA.
68. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained a management, accounting and information system, which recognised revenue when it is earned, accounted for debtors and accounted for receipts of revenue, as required by section 64(2)(e) of the MFMA.

INTERNAL CONTROL

69. In accordance with the PAA and in terms of General Notice 1111 of 2010, issued in *Government Gazette 33872 of 15 December 2010*, I considered internal control relevant to my audit, but not for the purpose of expressing an opinion on the effectiveness of internal control. The matters reported below are limited to the significant deficiencies that resulted in the basis for disclaimer of opinion, the findings on the annual performance report and the findings on compliance with laws and regulations included in this report.

Leadership

70. The reasons for the findings reported include a level of leadership instability resulting in a lack of consequences for poor performance and transgressions, leadership not being responsive to the Auditor-General of South Africa's (AGSA) messages and not taking ownership to improve key controls as identified quarterly by the AGSA. The inability to appoint competently skilled individuals in critical positions in the finance unit furthermore hindered the establishment of an effective internal control environment resulting in an over reliance on consultants by the municipality to facilitate the preparation of its financial records. This over reliance on the outputs by consultants regarding the preparation of the financial statements, without interrogating and monitoring such outputs against initially set objectives, added to the deficiencies identified in the financial statement disclosures.
71. Leadership of the municipality did not implement a performance management system in line with the requirements of the MSA to facilitate the clarification of roles and responsibilities, to guide staff to effectively carry out their duties and to monitor the performance of staff. This was as a result of the change in management at the municipality during the financial year impacting on the implementation of the performance management system in a timely manner by the financial year end.
72. Management did not identify and mitigate the risk of unauthorised expenditure, as part of its budget and expenditure management. With regards to irregular expenditure, there was a lack of an effective internal monitoring system to determine, on the basis of a retrospective analysis, whether the authorised supply chain management processes were being followed and whether the desired objectives were being achieved to limit irregular expenditure. This was as a result of the destruction of supply chain management supporting documentation by a fire with adequate backup documentation not being available for verification.
73. Leadership did not exercise oversight responsibility over financial reporting and internal control. In addition, leadership did not perform a proper review of the financial statements prior to submission for audit, resulting in pervasive material errors not being identified and corrected in the financial statement disclosures.
74. Leadership did not exercise oversight over compliance with laws and regulations, and in particular compliance with the municipal supply chain management regulations, to prevent irregular, fruitless and wasteful and unauthorised expenditure. Furthermore, the risk relating to the safekeeping of supporting documentation and record keeping was not adequately mitigated, as evidenced by the destruction of the supply chain management office resulting in a limitation of audit scope.
75. The internal processes of the municipality did not adequately address the processes pertaining to the reporting of performance information, as well as compliance with laws and regulations. The budget of the municipality was overspent, the municipality incurred

unauthorised, irregular and wasteful expenditure resulting from procurement contracts, the annual report was not submitted on time, the performance information was not submitted for audit purposes and the municipality utilised funds earmarked for other purposes.

Financial and performance management

76. The monitoring of the key financial disciplines in relation to daily transacting, record keeping, monitoring the key controls in relation to the daily recording and processing of those transactions and the timely performance and review of critical reconciliations in relation to those transactions which results in the accurate reporting thereof, did not occur. Furthermore the finance unit lacks adequate, critical financial management and accounting skills. This impacts the municipality's ability to account for transactions, accurately, completely and in a timely manner, resulting in unreliable, inaccurate and incomplete financial records causing the disclaimer of audit opinion.
77. The performance of contractors and the status of accounting functions that is contracted out to the contractors are not reviewed and effectively monitored. Corrective action on under-performance by contractors is not formulated and implemented in a timely manner in order to avoid the late submission of the financial statements.

Governance

78. The audit committee did not promote accountability and service delivery through evaluating and monitoring responses to risks and providing oversight over the effectiveness of the internal control environment including financial and performance reporting and compliance with laws and regulations. The audit committee did not meet prior to the submission of the financial statements to review the adequacy, reliability and accuracy of the financial statements. Furthermore, the audit committee failed to advise the municipal council, the political office bearers, the accounting officer and the management staff of the municipality on matters relating to compliance with the MFMA, the Division of Revenue Act and other applicable legislation.
79. Although a risk analysis has been performed by management, a risk strategy was not yet fully implemented and monitored
80. Management also did not ensure that an adequately resourced and functioning internal audit unit that identifies internal control deficiencies and recommends corrective action was established at the municipality during the period under review.

OTHER REPORTS

Investigations

81. The previous chief financial officer and municipal manager were suspended and replaced in the financial year under review. Formal disciplinary actions were implemented against these individuals. Formal charge sheets were prepared. Due to the cost implication of the disciplinary actions for both the individuals and the municipality, a formal agreement was reached between the parties to settle the matters. The two individuals, subsequently, resigned.
82. A formal forensic investigation was performed by the Port Elizabeth division of the South African Police Services in connection with the fire that occurred during August 2011 at the supply chain management department. The cause of the fire could not be determined, hence, the fire was classified as undetermined.

Auditor-General
Cape Town

24 August 2012



AUDITOR-GENERAL
SOUTH AFRICA

Auditing to build public confidence