

REPORT OF THE AUDITOR-GENERAL TO THE FREE STATE LEGISLATURE AND THE COUNCIL ON THE MALUTI WATER (PTY) LTD

REPORT ON THE FINANCIAL STATEMENTS

Introduction

1. I was engaged to audit the financial statements of Maluti Water (Pty) Ltd set out on pages xx to xx, which comprise the statement of financial position as at 30 June 2012, the statement of financial performance, statement of changes in net assets and cash flow statement for the year then ended, and 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 the 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 Companies Act of South Africa, 2008 (Act No. 71 of 2008), 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 the financial statements based on conducting the audit in accordance with the Public Audit Act of South Africa, 2004 (Act No. 25 of 2004) (PAA), the *General Notice* issued in terms thereof and International Standards on Auditing. 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

Inventory

4. The entity did not have sufficient controls in place to ensure proper control over the issue of inventory and could not provide sufficient, appropriate audit evidence for inventory purchased amounting to R1 260 897 (2011: R3 211 938). The inventory count was furthermore not attended by me nor was I able to perform alternative audit procedures in order to audit the existence and valuation of inventory. Consequently, I could not determine whether any further adjustments were necessary to the amount disclosed for inventory.

VAT receivable

5. VAT receivable as set out in note 5 to the financial statements is overstated by R1 530 532 (2011: (R534 756)) and expenditure is understated by the same amount due to the fact that the entity made calculation errors for VAT receivable for the year under review.

Cash and cash equivalents

6. The entity's bank reconciliations included invalid reconciling items for which no sufficient appropriate supporting documentation could be provided. I was unable to confirm the amounts by alternative means. Consequently, I was unable to determine whether the bank reconciliations were accurate and whether the cash and cash equivalents as set out in note 7 to the financial statements amounting to R4 844 109 (2011: R8 865 376) was valued correctly and whether any further adjustments were necessary to the amount disclosed for cash and cash equivalents.

Trade and other receivables

7. I was unable to obtain sufficient appropriate audit evidence as to the completeness, existence, valuation and allocation of trade and other receivables amounting to R42 053 657 (2011: R22 330 380) as set out in note 6 to the financial statements due to the fact that the client did not implement a sufficient and effective filing system to safeguard supporting documentation. I was unable to confirm the amount disclosed by alternative means. Consequently, I was unable to determine whether any further adjustments were necessary to the amount disclosed for trade and other receivables.

Property, plant and equipment

8. The entity was unable to provide me with sufficient appropriate supporting documentation to confirm property, plant and equipment. This was mainly due to a lack of sufficient controls to ensure the proper management of fixed assets. Consequently, I was unable to confirm property, plant and equipment amounting to R4 694 679 as set out in note 8 to the financial statements.

Finance lease liability

9. The entity was unable to provide me with sufficient appropriate audit evidence for the basis of calculations used for finance lease liabilities amounting to R403 113 (R2011: 547 267) as set out in note 11 and finance costs as set out in note 24 to the financial statements. I was unable to confirm the valuation of the amount disclosed by alternative means. Consequently, I could not determine whether further adjustments were required for the amount disclosed for finance lease liability.

Trade and other payables

10. Sufficient appropriate supporting documentation amounting to R6 867 592 for the 2011 financial year could not be provided for audit evidence. I was unable to confirm the accuracy and occurrence of the amount disclosed by alternative means. Consequently, I could not audit trade and other payables as set out in note 12 to the financial statements.

Accumulated deficit

11. A difference of R4 078 346 was identified between the balance disclosed as at 1 July 2010 per the previous audited financial statements and the current year balance. I was unable to confirm the amount disclosed by alternative means. Consequently, I was unable to determine whether any further adjustments were necessary to the amount disclosed as accumulated deficit in the statement of changes in net assets for the current and previous financial year.

Service charges

12. Service charges were accounted for when cash was received from customers. Consequently, the entity did not accrue for all income as required by SA GRAP 1, *Presentation of financial statements*. Service charges amounting to R39 071 091 (2011:28 429 484) as set out in note 16 and trade and other receivables from exchanges transactions amounting to R42 053 657 (2011: R22 330 380) is consequently understated by an unknown amount.

Government grants and subsidies

13. The entity could not provide us with sufficient, appropriate audit evidence regarding journals amounting to R6 198 916 due to the fact that the entity did not have a sufficient and effective system in place to ensure the safekeeping of supporting documentation. Amounts owed and receivable from the parent municipality was furthermore set off against grants received. I was unable to confirm the amount disclosed by alternative means. Consequently, I was unable to determine whether any further adjustments were necessary to the amount disclosed for government grants and subsidies.

Bulk purchases

14. Sufficient appropriate supporting documentation amounting to R5 936 707 could not be provided for audit evidence. I was unable to confirm the accuracy and occurrence of the amount disclosed by alternative means. Consequently, I could not audit the accuracy of bulk purchases as set out in note 29 to the financial statements.

Expenditure

15. The entity recognised expenses when the expense was paid and not when the expense was incurred as required by SA GRAP1, *Presentation of financial statements*. Consequently, expenditure as disclosed in the statement of financial performance is understated with an unknown amount.

Employee related cost

16. Sufficient appropriate supporting documentation for allowances amounting to R5 574 405 could not be provided for audit evidence. This was mainly due to the fact that the entity did not have sufficient filing systems in place to ensure the safeguarding of supporting documentation. I was unable to confirm the amount by alternative means. Consequently, I was unable to determine whether any further adjustments were necessary to the amount disclosed for other allowances as set out in note 20 to the financial statements.

Contingent liabilities

17. The entity did not have sufficient internal policies in place to ensure the accuracy and completeness of contingent liabilities as set out in note 34 to the financial statements. I was unable to confirm the existence and completeness of the disclosed amount. Consequently, I was unable to determine whether any further adjustments were required.

Related party transactions

18. I was unable to obtain sufficient appropriate audit evidence as to the accuracy of related party transactions as set out in note 36 to the financial statements. I was unable to confirm these amounts disclosed by alternative means. Consequently, I was unable to determine whether any further adjustments were necessary to these amounts disclosed for related party transactions for the current and the prior period.

Prior period errors

19. The entity corrected prior period errors in the current financial year. Sufficient, appropriate supporting documentation for adjusting journals could not be provided for audit evidence. Further adjustments amounting to R7 074 753 was identified during the audit which were not disclosed in the current financial statements as prior period errors as set out in note 38. Consequently, the disclosure for prior period errors is incomplete. I could furthermore not determine the valuation of the amounts currently disclosed in the financial statements.

Irregular and Fruitless and wasteful expenditure

20. The entity did not have sufficient policies and procedures in place to identify and ensure the completeness of irregular and fruitless and wasteful expenditure. Furthermore, sufficient appropriate audit evidence could not be provided for expenditure amounting to R653 746 and R11 915 066 for fruitless and wasteful and irregular expenditure respectively. I was unable to confirm the amount disclosed by alternative means. Consequently, I could not confirm whether any adjustments were required for the amount disclosed as irregular and fruitless and wasteful expenditure for the current and the prior period.

Retirement benefit information

21. The entity was unable to provide me with sufficient appropriate supporting documentation for retirement benefit information as set out in note 48 to the financial statements. I was unable to confirm the amount disclosed by alternative means. Consequently, I was unable to audit the valuation and existence of retirement benefit contribution amounting to R8 483 618 and to determine whether any further adjustments were required.

Events after reporting date

22. The entity did not have sufficient policies and procedures in place to identify subsequent events as required by SA Standards of GRAP, GRAP 14, *Events after reporting date*. Consequently, I could not determine whether any adjustments were required to the amount disclosed as events after reporting date.

Disclosure notes

23. A difference of R1 267 585 between the current year amounts for cash and cash equivalents as set out in note 40 to the financial statements and cash and cash equivalents as per the statement of financial performance was identified. This was because the entity do not have sufficient and effective procedures in place to ensure that financial statements are accurate and correct before submission for audit.
24. Differences amounting to R9 648 885 were identified between prior period amounts used for accumulated profit and net assets as set out in note 41 to the financial statements and the statement of financial performance. This was because the entity do not have sufficient and effective procedures in place to ensure that financial statements are accurate and correct before submission for audit.

Financial systems conversion

25. The entity migrated to a new financial system during the year under review. Sufficient, appropriate audit evidence could not be provided for audit purposes to ensure the accuracy and completeness of the balances taken over to the new system. The accuracy and completeness of financial data supporting the financial statements could consequently not be determined.

Cash flow statement

26. I was unable to obtain sufficient appropriate audit evidence to determine whether the cash flow statement and the related notes were fairly stated for the current and prior year. Taking into account the misstatements and scope limitations identified in the financial statements, as set out in this report, I was unable to practically quantify the misstatements in the cash flow statement and notes thereto. Consequently, I was unable to determine the accuracy, completeness and correct disclosure of the cash flow statement and related notes.

Disclaimer of opinion

27. 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

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

Material uncertainty

29. With reference to note 34 and 35 to the financial statements, contingent liabilities and assets, the entity is the defendant and recipient in two possible claims. The ultimate outcome of these matters cannot presently be determined. A provision for any liability that may result from these contingent liabilities has not been made in the financial statements.

Going concern

30. With reference 41 to the financial statements, the entity's liabilities exceed its assets with a material amount. The ability to continue as a going concern is dependent on a agreement by Maluti-a-Phofung Local Municipality to transfer revenue billed for water and sewerage and debtors to the entity.

Additional matters

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

Material inconsistencies in other information included in the annual report

32. I have not obtained the other information included in the annual report and have not been able to identify any material inconsistencies with the annual financial statements.

Unaudited supplementary schedules

33. The supplementary information set out on pages xx to xx does not form part of the financial statements and is presented as additional information. I have not audited these schedules and accordingly I do not express an opinion thereon.

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

In accordance with the PAA and the *General Notice* issued in terms thereof, I report the following findings relevant to performance against predetermined objectives, compliance with laws and regulations and internal control, but not for the purpose of expressing an opinion.

Predetermined objectives

34. The annual performance report included in the annual report was not presented in time for audit and consequently my findings below are limited to the procedures performed on the strategic planning and performance management documents.
35. The information was assessed to determine whether performance indicators and targets are measurable (i.e. well defined, verifiable, specific, measurable and time bound) and relevant as required by the *National Treasury Framework for managing programme performance information*.
36. The material findings are as follows:

Usefulness of information

37. The *National Treasury Framework for managing programme predetermined objectives* (FMPPI) requires that it must be possible to validate the processes and systems that produce the indicator. All (100%) of the measures relevant to the objectives were not verifiable in that valid processes and systems that produce the information on actual performance did not exist.

38. This was due to the lack of key controls in the relevant systems of collection, collation, verification and documentation relating to actual predetermined objectives.
39. Improvement measures in the annual performance report for a total of 60% of the planned targets not reached were not disclosed as required by section 46 of the MSA. This was due to inadequate internal policies and procedures over the processes pertaining to the reporting of performance information.

Consistency

40. The MSA requires that the integrated development plan should form the basis for annual report, therefore requiring the consistency of objectives, indicators and targets between planning and reporting documents. All (100%) of the reported objectives are not consistent and/or included as per the approved service level agreement. This is due to a lack of proper monitoring and review of the performance objectives included in the annual report.

Measurability

41. The FMPPI requires that performance targets be specific in clearly identifying the nature and required level of performance. All (100%) of targets were not specific in clearly identifying the nature and the required level of performance.
42. This was due to the fact that management was aware of the requirements of the FMPPI but did not receive the necessary training to enable application of the principles.

Compliance with laws and regulations

43. I performed procedures to obtain evidence that the entity has complied with applicable laws and regulations regarding financial matters, financial management and other related matters. My findings on material non-compliance with specific matters in key applicable laws and regulations as set out in the *General Notice* issued in terms of the PAA are as follows:

Budgets

44. Expenditure was incurred that was not budgeted for / in excess of the limits of the amounts provided for in the votes of the approved budget, in contravention of section 87(8) of the Municipal Finance Management Act.
45. Sufficient appropriate audit evidence could not be obtained that monthly budget statements were submitted to the accounting officer of the parent municipality, as required by section 87(11) of the Municipal Finance Management Act.

Annual financial statements, performance and annual reports

46. The financial statements submitted for auditing were not prepared in all material respects in accordance with the requirements of section 122 of the MFMA. Material misstatements identified by the auditors in the submitted financial statements were not adequately corrected and the supporting records could not be provided subsequently, which resulted in the financial statements receiving a disclaimer audit opinion.

Audit committee

47. The audit committee did not review the annual financial statements to provide the council with an authoritative and credible view of the financial position of the entity, its efficiency and effectiveness and its overall level of compliance with the MFMA, DoRA and (other applicable legislation), as required by section 166(2)(b) of the Municipal Finance and Management Act.

Internal audit

48. The internal audit unit did not report to the audit committee on matters relating to compliance with the MFMA, the Division of Revenue Act and other applicable legislation, as required by section 165(2)(b) of the MFMA.
49. The internal audit did not audit the results of performance measurements, as required by section 45(1)(a) of the Municipal Systems Act and Municipal Planning and Performance Management Regulation 14(1)(a).
50. The internal audit unit did not audit the performance measurements on a continuous basis and did not submit quarterly reports on their audits to the municipal manager and the performance audit committee, as required by Municipal Planning and Performance Management Regulation 14(1)(c).
51. Internal audit did not evaluate the reliability and integrity of financial and operational information as required by TR 3.2.11(b).

Procurement and contract management

52. A tender register as required by section 95 of the MFMA which include all tenders for the year under review could not be obtained for audit purposes.
53. The bid evaluation committee did not submit, within 5 days, a written report containing particulars of each final award made by the committee during the month as required by section 5(3) and (4) of the SCM.
54. The performance of contractors or service providers was not monitored on a monthly basis, as required by section 116(2)(b) of the MFMA.
55. Sufficient appropriate audit evidence could not be obtained that all contracts were awarded and quotations were accepted in accordance with the legislative requirements and a procurement process which is fair, equitable, transparent and competitive, as all required information could not be provided for audit.

Human resource management and compensation

- 56. The entity did not report to the parent municipality on the competency levels of staff as required by section 14 (3) of the Municipal Regulations on Minimum Competency Levels.
- 57. The performance of personnel were not effectively monitored as required by section 39(a), (b) and 40 of the Municipal Systems Act (Act No. 32 of 2000)

Expenditure management

- 58. Sufficient appropriate audit evidence could not be obtained that money owing by the municipal entity had always been paid within 30 days of receiving an invoice or statement, as required by section 99(2)(b) of the Municipal Finance Management Act.
- 59. An effective system of expenditure control, including procedures for the approval, authorisation, withdrawal and payment of funds, was not in place as required by section 99(2)(a) of the Municipal Finance Management Act.
- 60. An adequate management, accounting and information system was not in place which recognised expenditure when it was incurred and accounted for creditors, as required by section 99(2)(c) of the Municipal Finance Management Act.
- 61. The accounting officer did not take effective steps to prevent irregular expenditure and/or fruitless and wasteful expenditure, as required by section 95(d) of the Municipal Finance Management Act.
- 62. The accounting officer did not always report to the South African Police Service cases of alleged irregular expenditure that constituted a criminal offence / theft and fraud that occurred in the entity/ losses suffered as a result of criminal conduct, as required by section 102(2) of the Municipal Finance Management Act.

Financial misconduct

- 63. Investigations were not instituted into all allegations of financial misconduct against officials of the entity, as required by section 171(4)(a) of the MFMA due to the fact that irregular was incurred but was not investigated.

Revenue management

- 64. An adequate management, accounting and information system was not in place which recognised revenue when it was earned, as required by section 97(h) of the Municipal Finance Management Act.
- 65. Sufficient audit evidence could not be obtained that revenue had been reconciled on a weekly basis, as required by 98(a) of the Municipal Finance Management Act.

Asset management

- 66. An adequate management, accounting and information system which accounts for assets was not in place, as required by section 96(2)(a) of the Municipal Finance Management Act.
- 67. An effective system of internal control for assets (including an asset register) was not in place, as required by section 96(2)(b) of the Municipal Finance Management Act.

Internal control

68. I considered internal control relevant to my audit of the financial statements, annual performance report and compliance with laws and regulations. The matters reported below under the fundamentals of internal control 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

69. The chief executive officer position was vacant for the year under review.
70. Leadership did not evaluate whether management had implemented effective internal controls by gaining an understanding of how senior management members had met their responsibilities in terms of preparing bank reconciliations, ensuring proper records management, maintaining an asset register and preparing the annual financial statements.
71. Leadership did not take timeous and adequate action to address weaknesses in the finance and supply chain management directorate, which resulted in non-compliance with applicable legislation and gave rise to fruitless and wasteful and irregular expenditure.
72. Leadership of the entity did not ensure that internal control procedures were developed, implemented and monitored to ensure that daily disciplines were performed and reviewed.
73. The lack of decisive action to mitigate emerging risks, implement timely corrective measures and address non-performance was evident by the failure of management to adequately address the external audit findings in a timely manner. The entity failed to properly analyse the control weaknesses and implement appropriate follow-up actions that adequately addressed the root cause. This resulted in the audit findings in the prior year report being recurring in the current year.
74. Leadership failed to implement adequate controls to ensure compliance with laws, regulations and internally designed policies and procedures. As a result, significant non-compliance issues were noted.

Financial and performance management

75. Effective performance systems, processes and procedures as well as the management thereof had not been adequately developed and implemented.
76. Inadequate filing procedures at the entity resulted in limitations of scope during the current and previous year's audits. As a result significant difficulties were experienced in respect of the availability of information.
77. The financial statements were not properly reviewed for completeness and accuracy prior to submission for auditing. This resulted in many findings relating to incorrect disclosure.
78. The entity did not have the capacity to address backlog issues and financial system problems, resulting in the need to appoint consultants. Consultants assisted with the preparation of an asset register and financial statements.
79. Finance staff had an insufficient understanding of the accounting framework. This contributed towards the numerous qualifications in the financial statements of the entity.

Governance

80. The financial statements contained numerous inaccuracies, which are attributable to weaknesses in the design and implementation of internal control in respect of financial management and financial reporting, and weaknesses in the information systems.
81. The entity did not have a documented fraud prevention plan. Internal control deficiencies were not identified and communicated in a timely manner to allow for corrective action to be taken. The implementation of external audit recommendations was not monitored. This resulted in the prior year audit findings not being substantially addressed.

Auditor - General

Bloemfontein

13 February 2013



AUDITOR - GENERAL
SOUTH AFRICA

Auditing to build public confidence