

REPORT OF THE AUDITOR-GENERAL TO THE MUNICIPAL COUNCIL AND THE EASTERN CAPE PROVINCIAL LEGISLATURE ON THE FINANCIAL STATEMENTS AND PERFORMANCE INFORMATION OF THE CHRIS HANI DISTRICT MUNICIPALITY FOR THE YEAR ENDED 30 JUNE 2007

REPORT ON THE FINANCIAL STATEMENTS

Introduction

1. I have audited the accompanying financial statements of the Chris Hani District Municipality which comprise the statement of financial position as at 30 June 2007, 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 notes, and the accounting officer's report, as set out on pages ... to ...

Responsibility of the accounting officer for the financial statements

2. The accounting officer is responsible for the preparation and fair presentation of these financial statements in accordance with the basis of accounting determined by the National Treasury, as set out in accounting policy note 1 and in the manner required by the Local Government: Municipal Finance Management Act, 2003 (Act No. 56 of 2003) (MFMA). This responsibility includes:
 - designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error
 - selecting and applying appropriate accounting policies
 - making accounting estimates that are reasonable in the circumstances.

Responsibility of the Auditor-General

3. As required by section 188 of the Constitution of the Republic of South Africa, 1996 read with section 4 of the Public Audit Act, 2004 (Act No. 25 of 2004) (PAA), my responsibility is to express an opinion on these financial statements based on my audit.
4. I conducted my audit in accordance with the International Standards on Auditing. Those standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.
5. 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 and fair presentation 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.
6. An audit also includes evaluating the:
 - appropriateness of accounting policies used

- reasonableness of accounting estimates made by management
 - overall presentation of the financial statements.
7. Paragraph 11 et seq. of the Statement of Generally Recognised Accounting Practice, GRAP1 *Presentation of Financial Statements* requires that financial reporting by entities shall provide information on whether resources were obtained and used in accordance with the legally adopted budget. As the budget reporting standard is still in the process of being developed, I have determined that my audit of any disclosures made by the Chris Hani District Municipality in this respect will be limited to reporting on non-compliance with this disclosure requirement.
 8. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

Basis of accounting

9. The municipality's policy is to prepare financial statements on the basis of accounting determined by the National Treasury as set out in accounting policy note 1.

Basis for adverse opinion

Basis of preparation

10. In terms of the requirements of *General Notice 552 of 2007*, issued in *Government Gazette No. 30013 of 29 June 2007*, the district municipality applied for and was granted all the exemptions made available by National Treasury. Accounting policy note 1 indicates that these exemptions were applied in the preparation of the financial statements. Further accounting policy notes, however, contradict accounting policy note 1 and indicate that these exemptions were not consistently applied in that the accounting policies disclosed were not amended to indicate how the exemption was taken into account and how the policy was amended. In addition, no disclosure was made of the fact that comparatives may not be consistent with the current year accounting policies due to the application of the exemptions.
11. The municipality did not submit an implementation plan detailing progress towards full compliance with section 122(3) of the MFMA to the National and Provincial Treasuries before 30 October 2007, as required by the above general notice issued by National Treasury. Further, the financial statements did not include a report by the municipal manager detailing the progress made towards full compliance with GRAP, GAMAP and GAAP as well as an explanation of the extent to which the information in the financial statements would need to be adjusted to fully comply with GRAP, GAMAP and GAAP.
12. Management has an obligation to put in place controls to help it identify and implement the appropriate accounting frameworks and policies to structure and govern its financial management responsibilities, as required by the MFMA. Management is also required to properly analyse financial risk at account balance level and implement appropriate controls to minimise these risks. During my audit I noted a number of instances where management was not able to do this, leading to material misstatement of the financial position of the municipality.

13. As a result of the above, the accounting policy relating to the exemptions disclosed in accounting policy note 1 has not been aligned to the accounting treatment used by the municipality to prepare the financial statements. I am unable to quantify the effect of the above non-compliance with the accounting framework due to extensive scope limitations on the affected account balances which are detailed in the ensuing paragraphs.

Financial statements

14. Significant contradictions were found within the financial statements. These include:

- Amounts recovered from conditional grants disclosed in the statement of financial performance are stated as R192.2 million; however, when compared to the amount disclosed in note 18 to the financial statements, there is a difference of R1.1 million. The municipality did not provide adequate documentation in support of the difference and it was not possible to determine which amount was correct.
- Contributions to provisions disclosed in the statement of financial performance amount to R665 115; however, when compared to the amount disclosed in note 3 to the financial statements, there is a difference of R184 227. The municipality did not provide adequate documentation in support of the difference and it was not possible to determine which amount was correct.
- The statement of financial performance and note 28 to the financial statements reflect an amount of interest paid of R306 573; however, interest paid disclosed in the cash flow statement amounts to R223 545. Documentation was provided in support of interest paid amounting to R223 545; however, the municipality was not able to provide an explanation for the difference of R83 028.
- Investment interest received amounting to R7.7 million was disclosed in the statement of financial performance; however, when compared to the amount disclosed in the cash flow statement, there is a difference of R212 407. Documentation was provided in support of interest received amounting to R7.7 million; however, the municipality was not able to provide an explanation for the difference of R212 407.
- The comparative amounts disclosed in the statement of changes in net assets differ from those disclosed in the trial balance provided in support of the amounts disclosed in the financial statements. Details are as follows:
 - Net surplus for the year as per statement of changes in net assets amounts to R27.2 million and the amount disclosed in the trial balance amounts to R26.4 million, reflecting a difference of R 763 419. The municipality did not provide documentation in support of this difference.
 - Adjustment to accumulated depreciation disclosed in the statement of changes in net assets amounts to R1.3 million; however, the trial balance does not indicate this amount, reflecting a difference of R1.3 million. The municipality did not provide documentation in support of this difference.
 - Transactions current year disclosed in the statement of changes in net assets amount to a negative amount of R534 529; however, the trial balance reflects a positive amount of R1.2 million, resulting in a difference

of R1.7 million. The municipality did not provide documentation in support of the difference.

- Transactions previous year disclosed in the statement of changes in net assets amount to R10.9 million; however, the trial balance reflects an amount of R12.6 million, resulting in a difference of R1.7 million. The municipality did not provide documentation in support of this difference.
 - Offsetting depreciation is disclosed in the statement of changes in net assets as R1.4 million; however, the trial balance does not indicate this amount, reflecting a difference of R1.4 million. The municipality did not provide documentation in support of this difference.
 - The budgeted amount for employee costs could not be reconciled between the financial statements, the approved budget and revised budget. In addition, no evidence was provided in support of the approval obtained for the revised budget as required in terms of section 28(4) of the MFMA.
15. The incorrect application of the exemptions, together with the above unadjusted errors, has resulted in the financial statements being fundamentally incorrect.

General journals

16. General journals with a debit value of R579,2 million and a credit value of R872,6 million submitted for audit purposes did not have adequate and appropriate documentation to support the transactions that they represented. This is as a result of ineffective controls in operation, including reviewing, checking and reconciling of source documentation.
17. Consequently, it was not possible to obtain all the information and explanations that were considered necessary to gain assurance as to the validity, accuracy and completeness of account balances and classes of transactions as contained in the financial statements.

Suspense accounts

18. Suspense accounts amounting to R1.2 million (2006: R24.3 million) remained uncleared at year-end. The opening balance differs from the prior year closing balance, as reported on, by R180 892.
19. A complete listing of originating and clearing entries totalling R23.3 million, posted to the suspense accounts as well as supporting documentation could not be provided for audit purposes.
20. In light of the above, it was not possible to obtain all the information and explanations that were considered necessary to gain assurance as to the validity, accuracy and completeness of account balances and classes of transactions as contained in the financial statements.

Consumer and other debtors

21. Consumer debtors are disclosed as R5.6 million in note 13 to the financial statements. The district municipality's age analysis provided in support of consumer debtors referred to above reflected a difference of R107.7 million. Management was not able to provide an explanation in support of this difference and numerous discrepancies with respect to existence of the debtors disclosed were identified. Based on the above, I am not able to rely on the integrity of the age analysis provided in support of consumer debtors disclosed as R5.6 million.
22. Other debtors are disclosed as R49.4 million in note 14 to the financial statements. No evidence could be provided in support of the existence of other debtor balances totalling R34.6 million included in the amount of R49.4 million referred to above. No subsequent payments were received from these debtors to confirm the existence thereof by alternative means. Furthermore, documentation in support of debit debtor balances totalling R24.8 million included in the above amount of R34.6 million and credit debtor balances totalling R932 143 could not be provided for audit purposes.
23. The district municipality does not have a bad debt provision policy which enables it to identify potential bad debts. The municipality increased the provision by R3.1 million in the current year to R10.7 million at 30 June 2007, as disclosed in note 14 to the financial statements; however, we were not able to assess the reasonableness of this provision as no evidence was provided in support of the provision. As a result of the above findings and the lack of documentation in support of the existence of consumer and other debtors disclosed, the bad debt provision is misstated; however, it is not possible to determine the extent of the misstatement of the bad debts provision disclosed.
24. Consequently, it was not possible to confirm the existence of debtors disclosed, and the completeness and valuation of consumer and other debtor balances totalling R55 million as disclosed in the financial statements.

Creditors

25. Creditors amounting to R14.8 million as disclosed in note 6 to the financial statements are considered to be understated by an amount of R3.4 million. This amount is made up of an amount owed to the South African Revenue Services (SARS) for Pay As You Earn (PAYE) of R501 883 which was paid subsequent to year-end but not raised as an accrual as at 30 June 2007, and an amount of R2.9 million owed to Lukhanji Municipality in relation to the transfer of the water function to the district municipality. The district municipality has not included the amount owing as a creditor despite having provided Lukhanji Municipality with a confirmation of the amount owed to them in this regard.

Value-added tax (VAT)

26. According to the SARS approval in our possession, the district municipality was registered for VAT on the invoice basis for the period under review. The municipality changed the basis on which they are registered for VAT to the payments basis from 1 July 2007, which is subsequent to the current year-end date of 30 June 2007. Our testing revealed that the municipality is not consistent in accounting for VAT and has accounted for VAT on both bases during the year under review. The timing

difference between these approaches results in unaccounted VAT debtor and VAT creditor balances. The full extent of such differences could not be determined and the accuracy and measurement of VAT transactions and the valuation and completeness of the balance of R5 million included in note 8 to the financial statements could not be verified.

Bank

27. In terms of paragraph 1.42 of GRAP1: Presentation of Financial Statements, the municipality is required to disclose the bank overdraft separately under current liabilities. This was not done as the bank overdraft of R8.6 million has been included with favourable call account balances of R188.4 million. The bank balance as disclosed in note 15 to financial statements is therefore understated by R8.6 million and current liabilities are understated by the same amount. Further, in terms of section 45(2) of the MFMA, the district municipality is required to obtain a council resolution in order to incur short-term debt, including bank overdrafts. No evidence of approval having been obtained to incur such overdraft could be provided.
28. In addition, the opening balance for cash and bank per the current year trial balance differs from the prior year's closing balance by R180 892. Management was unable to provide an explanation for this. The bank reconciliation included historic reconciling items totalling R3.1 million for which no supporting documentation was provided for audit purposes. This matter was reported in the 2005-06 audit report.
29. Consequently, it was not possible to obtain assurance with respect to the accuracy and classification of the bank balance disclosed.

Property, plant and equipment

30. In terms of section 95(b) of the MFMA, the accounting officer should ensure that full and proper records of the financial affairs of the entity are kept. However, adequate control was not exercised over assets during the year under review. This is as a result of asset records not being continuously and effectively monitored by management. The asset register is deficient in that it is not completely and accurately populated and therefore not adequately maintained and not supported by sufficient appropriate documentation. Based on the above deficiencies, it was also not possible to locate assets for physical verification thereof.
31. In addition, separate accounts do not exist in the general ledger for the various categories of depreciation and accumulated depreciation. Consolidated journal entries, amounting to R3.6 million, used to capture depreciation, were not accompanied by detailed supporting documentation and instances were noted where depreciation was not calculated on certain assets.
32. Consequently, it was not possible to verify the completeness, existence and classification of property, plant and equipment amounting to R23.7 million as disclosed in note 9 to the financial statements.

Reserves

33. The capital replacement reserve as disclosed in the statement of financial position as at 30 June 2007 amounts to R21 million. Included in the movement of this account balance is an amount of R 645 534 pertaining to interest earned. The accuracy of the above interest earned could not be established due to inadequate supporting documentation.
34. Material differences relating to the movements of balances included in the accumulated surplus of R63.9 million, as disclosed in the statement of financial position as at 30 June 2007, were noted between the statement of changes in net assets and the trial balance. Included in the movement, is an amount of R10.9 million relating to a prior year adjustment for which there is no description in the financial statements and no supporting documentation to verify the validity of the transaction. In addition, no supporting documentation or detailed calculations were provided substantiating all movements relating to the accumulated surplus, comprising debit entries totalling R982.2 million and credit entries of R993.1 million.
35. Consequently, it was not possible to verify the completeness, accuracy as well as classification and disclosure of these reserves.

Government grants and reserves

36. No evidence was provided to indicate that the municipality prepared reconciliations of grant funds received and utilised. It is evident from the findings below that the controls around the administration of grant funding are inadequate. Due to the lack of supporting documentation and the inadequacy of the accounting treatment of the conditional grant funding, it was not possible to verify whether the funds were used in accordance with the conditions of each grant and whether the funds had been used to incur operational expenditure instead of conditional grant expenditure. This could result in irregular expenditure due to non-compliance with the Division of Revenue Act, 2006 (Act No. 2 of 2006) (DoRA), the extent of which is not determinable due to the scope limitation mentioned above.
37. Government grants and subsidies received for the current year are disclosed in note 18 to the financial statements as R328 million. This amount is made up of Equitable Share received to the amount of R117 million, Provincial Grants and Subsidies received to the amount of R12.1 million and National / Provincial Government Grants Reimbursements to the amount of R198.8 million. The documentation provided in support of the conditional grants received did not agree to that which was disclosed in the financial statements in that it was inadequate and therefore audit assurance could not be obtained for the difference of R102.7 million. Management was not able to provide an adequate explanation for the difference. In addition, no supporting documentation was provided to explain a difference of R4.6 million between the equitable share allocation per DoRA and that which is recorded in the financial statements.
38. The statement of net assets reflects an R8.3 million increase in the government grant reserve of R13.6 million, as disclosed in the statement of financial position as at 30 June 2007 with regard to the financing of assets. There is no corresponding transfer from the accumulated surplus; however, there is an increase of R1.8 million in

accumulated surplus. There is uncertainty as to the validity of these movements since the transfers should net off. Further, it was not possible to trace assets purchased with funds from the government grant reserve in the asset register. Depreciation of R1.4 million relating these asset purchases could not be recalculated due to uncertainty as to their existence.

39. The government grant reserve, disclosed at R13.6 million, has not been accounted for in terms of paragraphs 24 and 26 of IAS20 since it has not been presented as deferred income that is recognised as income on a systematic and rational basis over the useful life of the asset.

Expenditure

40. Disclosed in the statement of financial performance are General Expenses -Other to the amount of R57.2 million. Included in this amount is project expenditure to the amount of R32 million for which insufficient supporting documentation was provided for audit purposes. This resulted in a scope limitation and it was not possible to confirm the accuracy of the expenditure incurred and the completeness of the infrastructure project listing, including movement on each project.

Accrued leave pay

41. Leave records were generally found to be in an unsatisfactory state. Leave records had not been regularly updated and leave forms had not been timeously filed in personnel files. In certain instances, attendance registers were not submitted for audit and errors in capturing leave were noted. A recalculation of leave days revealed a significant number of differences between the leave administration system and leave records. The leave records on the personnel system have been used as the basis for calculating the R3.3 million leave accrual disclosed as non-current provision and current portion of leave pay provision to the amount of R1.4 million and R1.9 million respectively in notes 3 and 4 to the financial statements. Consequently, the completeness, accuracy and valuation of the leave provision could not be verified.

Unauthorised expenditure

42. Interest paid on external borrowings amounting to R306 573 as disclosed in note 23 to the financial statements was not budgeted for in the approved budget and not subsequently included in the revised budget (albeit unapproved), resulting in unauthorised expenditure. The above unauthorised expenditure has not been adequately disclosed in the financial statements and there is no evidence that the requirements of section 32 of the MFMA have been met.

Adverse opinion

43. In my opinion, because of the significance of the matters described in the Basis for adverse opinion paragraphs, the financial statements do not present fairly, in all material respects, the financial position of the Chris Hani District Municipality as at 30 June 2007 and its financial performance and cash flows for the year then ended, in accordance with the basis of accounting determined by the National Treasury, as set out in accounting policy note 1 and in the manner required by the MFMA.

OTHER MATTERS

I draw attention to the following matters that are ancillary to my responsibilities in the audit of the financial statements:

Non-compliance with applicable legislation

45. No evidence could be provided that the district municipality had complied with section 26(2)(a) of DoRA in terms of which the receiving officer must indicate and make public the intended use of funds.

Matters of governance

Risk assessment

46. There are no approved fraud prevention and risk assessment plans at the district municipality. This increases the risk of fraud and error within all major business cycles.

Internal audit

47. The internal audit unit was ineffective for the period under review as a result of significant weaknesses identified. Furthermore, several deficiencies were noted in the internal audit charter.

Material corrections made to the financial statements submitted for audit

48. The financial statements, approved by the accounting officer and resubmitted for audit on 25 January 2008, have been significantly revised because of the following misstatements identified during the audit:

- Comparative amount for other debtors per notes reduced by R3.4 million to agree to statement of financial position.
- Comparative amount for government grants and subsidies increased by R2 million to agree to statement of financial performance.
- Transfer to capital replacement reserve of R10 million recognised in statement of changes in net assets, having previously been expensed in the statement of financial performance.

Internal control

49. Section 62(1)(c)(i) of the MFMA states that the accounting officer must ensure that the municipality has and maintains effective, efficient and transparent systems of financial and risk management and internal control. The table below depicts the root causes of the matters indicated, as they relate to the five components of internal control. In some instances deficiencies exist in more than one internal control component.

Reporting item	Control environment	Assessment of risks	Control activities	Information and communication	Monitoring
Basis for adverse opinion					
Basis of preparation			X		
Financial statements	X				
General journals	X				
Suspense accounts	X				
Consumer and other debtors			X		
Creditors			X		
Value-added tax (VAT)			X		
Bank			X		
Property, plant and equipment	X				
Reserves			X		
Government grants and subsidies	X				
Expenditure			X		
Accrued leave pay			X		
Unauthorised expenditure	X				
Other matters					

Reporting item	Control environment	Assessment of risks	Control activities	Information and communication	Monitoring
Non-compliance with applicable legislation	X				
Material corrections to the financial statements			X		
Matters of governance	X				

OTHER REPORTING RESPONSIBILITIES

Reporting on performance information

50. I was engaged to audit the performance information.

Responsibility of the accounting officer for the performance information

51. In terms of section 121(3)(c) of the MFMA, the annual report of a municipality must include the annual performance report of the municipality prepared by the municipality in terms of section 46 of the Local Government: Municipal Systems Act, 2000 (Act No. 32 of 2000) (MSA).

Responsibility of the Auditor-General

52. I conducted my engagement in accordance with section 13 of the PAA read with *General Notice 646 of 2007*, issued in *Government Gazette No. 646 of 25 May 2007* and section 45 of the MSA.

53. In terms of the foregoing my engagement included performing procedures of an audit nature to obtain sufficient appropriate evidence about the performance information and related systems, processes and procedures. The procedures selected depend on the auditor's judgement.

54. I believe that the evidence I have obtained is sufficient and appropriate to provide a basis for the audit findings reported below.

Audit findings (performance information)

Non-compliance with regulatory requirements

55. The following instances of non-compliance with regulatory requirements of the MSA were noted during the course of the audit:

- Chapter 6, section 39 (c) – The executive committee or executive mayor did not submit the proposed performance management system implementation policy to the municipal council for adoption.

Performance information not submitted timeously

56. The performance information was not submitted in time for such information to be audited.

Performance audit committee

57. The performance audit committee was ineffective for the period under review since there was no evidence of the review and reporting of performance information.

APPRECIATION

58. The assistance rendered by the staff of the Chris Hani District Municipality during the audit is sincerely appreciated.

East London

25 April 2008



A U D I T O R - G E N E R A L