

# Report of the auditor-general to Eastern Cape Provincial Legislature and the council on Makana Local Municipality

## Report on the financial statements

### Introduction

1. I have audited the financial statements of the Makana Local Municipality set out on pages ... to ..., which comprise statement of financial position as at 30 June 2016, the statement of financial performance, statement of changes in net asset, cash flow statement and statement of comparison of budget information with actual information for the year then ended, as well as the notes, comprising a summary of significant accounting policies and other explanatory information.

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

2. The accounting officer is responsible for the preparation and fair presentation of these financial statements in accordance with South African Standards of Generally Recognised Accounting Practice (SA standards of GRAP) and the requirements of the Municipal Finance Management Act of South Africa, 2003 (Act No. 56 of 2003) (MFMA) and Division of Revenue Act of South Africa, 2013 (Act No. 1 of 2015) (DoRA) and for such internal control as the accounting officer determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

### Auditor-general's responsibility

3. My responsibility is to express an opinion on these financial statements based on my audit. I conducted my audit in accordance with International Standards on Auditing. Those standards require that I comply with ethical requirements, and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.
4. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the municipality'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 municipality's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

## **Basis for Qualified Opinion**

### Property, plant and equipment (PPE)

6. The municipality did not account for infrastructure assets (IA) of PPE in accordance with GRAP 17: *Property, plant and equipment* correctly as disclosed in note 10 to the financial statements. Not all completed infrastructure assets (IA) were transferred from work in progress infrastructure (WIP) to the IA register. Consequently, IA as disclosed in note 10 to the financial statements is understated by R152,1 million and WIP is overstated by R152,1 million. Additionally, there was a resultant impact on the depreciation and amortisation for the period as disclosed in the statement of financial performance and note 29 to the financial statements. Due to the inadequate internal controls I was unable to determine the impact on the depreciation amount in respect of infrastructure assets. Even through alternative means, I was unable to determine whether any adjustments to the depreciation were necessary as it was impracticable to do so.

### Receivables from exchange transactions

7. I was unable to obtain sufficient appropriate audit evidence that the municipality had properly accounted for receivables for the current and prior year. This is due to the inadequate internal controls to record and collect revenue from billing. I was unable to confirm the balance by alternative means. Consequently, I was unable to determine whether any adjustment to the receivables from exchange transactions stated at R35,7 million (2015: R49,9 million) in the statement of financial position and note 5 to the financial statements was necessary.
8. Additionally, there was a resultant impact on the debt impairment for the period as disclosed in the statement of financial performance and note 32 to the financial statements. Due to the inadequate internal controls I was unable to determine the impact on the debt impairment. Even through alternative means, I was unable to determine whether any adjustments to the debt impairment were necessary as it was impracticable to do so.

### Payables from exchange and non-exchange

9. The municipality did not have adequate systems to maintain records of accounts payable for goods and services received but not yet paid. Consequently, payables from exchange and non-exchange as disclosed in the statement of financial position and note 15 to the financial statements was understated by R27,5 million and general expenditure as disclosed in the statement of financial performance and note 36 of the financial statements was understated by R27,5 million.
10. In addition, I was unable to obtain sufficient appropriate audit evidence for debtors with

credit balances and trade payables included in payables from exchange and non-exchange as disclosed in the statement of financial position and note 15 to the financial statements. I could not confirm the balance by alternative means. Consequently, I was unable to determine whether any further adjustments to payables from exchange and non-exchange to the amount of R131,1 million (2015: R140,6 million) was necessary.

## Value Added Tax (VAT)

11. The municipality did not have adequate systems to maintain records of VAT owed to the South African Revenue Service. Consequently, the VAT suspense as disclosed in the statement of financial position and note 9 to the financial statements was understated by R15,2 million (2015: R14,5 million). Due to the inadequate internal controls I could not determine the corresponding accounting entry required for this misstatement. Even through alternative means it was impracticable to determine the impact on other classes of transactions, account balances and disclosures within the financial statements.

## Employee related costs

12. The municipality did not have adequate systems to maintain records of employee related costs. Consequently, employee related costs as disclosed in the statement of financial performance and note 27 to the financial statements was overstated by R17,7 million. Due to the inadequate internal controls I could not determine the corresponding accounting entry required for this misstatement. Even through alternative means it was impracticable to determine the impact on other classes of transactions, account balances and disclosures within the financial statements.

## Irregular expenditure

13. The municipality did not have adequate systems to identify and disclose all irregular expenditure incurred during the year as required by section 125(2)(d)(i) of the MFMA. The irregular expenditure disclosed in note 43 to the financial statements is understated in respect of amounts incurred and identified during the audit process of R15 million. Due to the lack of systems it was impracticable to determine the full extent of the understatement of the irregular expenditure disclosed as R128,3 million (2015: R89,9 million) in note 43 to the financial statements.

## Cash flow statement

14. The presentation of the cash flow statement was not in accordance with GRAP 2: *Cash flow statements*. Cash flows from operating activities and cash flows from investing activities in the cash flow statement have been incorrectly presented. Consequently, the net decrease in cash and cash equivalents as disclosed on the cash flow statement is understated by R159 million (2015: R55,9 million).

## Restatement in corresponding figures

15. Sufficient and appropriate evidence was not available to support the changes made to

the comparative information disclosed in note 50 to the financial statements. This was due to the municipality not having adequate document management processes in place. I was unable to determine whether any further adjustments to the below prior period adjustments affecting the corresponding figures as disclosed in note 50 to the financial statements were necessary:

- Services charges of R171,2 million
- Employee costs of R135,1 million
- Debt impairment of R66,3 million
- Payables from non-exchange transactions of R16,5 million
- Vat receivable of R14. 5 million

## Corresponding figures

### Commitments

16. I was unable to obtain sufficient appropriate audit evidence regarding the commitments disclosure in the corresponding figure, as the commitments were presented in the financial statements for auditing purposes without accurate and complete underlying accounting records. I was unable to audit the disclosure in the financial statements by alternative means. Consequently, I was unable to determine whether any adjustments to commitments stated at R66,3 million in note 32 to the financial statements was necessary.

### Unauthorised Expenditure

17. I was unable to obtain sufficient appropriate audit evidence regarding the unauthorised expenditure disclosure in the corresponding figure, as the disclosure was presented in the financial statements for auditing purposes without accurate and complete underlying accounting records. I was unable to audit the disclosure in the financial statements by alternative means. Consequently, I was unable to determine whether any adjustments to the unauthorised expenditure of R225,2 million as disclosed in note 41 to the financial statements was necessary.

### Qualified opinion

18. In my opinion, except for the possible effects of the matters described in the basis for qualified opinion paragraphs, the financial statements present fairly, in all material respects, the financial position of the Makana Local Municipality as at 30 June 2016 and its financial performance and cash flows for the year then ended, in accordance with SA standards of GRAP and the requirements of the MFMA.

## **Emphasis of matters**

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

### **Material losses**

20. As disclosed in note 52 to the financial statements, the municipality incurred material losses relating to electricity of R38,6 million (2015: R31,1 million) due to the poor management of electricity connections and illegal electricity connections.

### **Significant uncertainties**

21. As disclosed in note 46 to the financial statements, the municipality was the defendant in a number of lawsuits estimated at R46,3 million (2015: R49 million). The outcome of these lawsuits cannot be determined at present as litigation is still in progress.

### **Fruitless and wasteful expenditure**

22. As disclosed in note 42 to the financial statements, fruitless and wasteful expenditure amounting to R9,9 million (2015: R5,8 million) was incurred by the municipality during the year ended 30 June 2016. This expenditure was as a result of interest paid on overdue payments.

### **Unauthorised expenditure**

23. Unauthorised expenditure of R253,7 million (2015: R225,2 million) has not been recovered, written off or condoned as disclosed in note 41 to the financial statements. Unauthorised expenditure of R28,6 million (2015: R31,8 million) incurred during the current year is included in the amount disclosed.

### **Restatement of corresponding figures**

24. As disclosed in note 50 to the financial statements, the corresponding figures for 30 June 2015 have been restated as a result of errors only corrected during the year ended 30 June 2016 that existed in the financial statements at, and for the year ended 30 June 2015.

## **Additional matters**

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

### **Unaudited supplementary schedules**

26. The supplementary information as set out on pages xxx to xxx does not form part the financial statements. We have not audited these schedules and accordingly we do not express an opinion thereon.

## Unaudited disclosures notes

27. In terms of section 125(2)(e) of the MFMA the municipality is required to disclose particulars of non-compliance with this legislation. This disclosure requirement did not form part of the audit of the financial statements and accordingly I do not express an opinion thereon.

## Report on other legal and regulatory requirements

28. In accordance with the Public Audit Act of South Africa, 2004 (Act No. 25 of 2004) and the general notice issued in terms thereof, I have a responsibility to report findings on the reported performance information against predetermined objectives of selected development priorities presented in the annual performance report, compliance with legislation and internal control. The objective of my tests was to identify reportable findings as described under each subheading but not to gather evidence to express assurance on these matters. Accordingly, I do not express an opinion or conclusion on these matters.

## Predetermined objectives

29. I performed procedures to obtain evidence about the usefulness and reliability of the reported performance information of the following selected development priority presented in the annual performance report of the municipality for the year ended 30 June 2016
- Development priority 5: Basic services and infrastructure on pages x to x.
30. I evaluated the usefulness of the reported performance information to determine whether it was presented in accordance with the National Treasury's annual reporting principles and whether the reported performance was consistent with the planned development priorities. I further performed tests to determine whether indicators and targets were well defined, verifiable, specific, measurable, time bound and relevant, as required by the National Treasury's *Framework for managing programme performance information* (FMPPI).
31. I assessed the reliability of the reported performance information to determine whether it was valid, accurate and complete.
32. The material findings in respect of the selected development priority are as follows:

## Basic services and infrastructure

### Usefulness of reported performance information

33. The FMPPI requires that performance indicators must be well defined by having clear data definitions so that data can be collected consistently and is easy to understand and

use. A total of 38% of the indicators were not well defined. This was due to a lack of proper systems and processes around performance management within the municipality

34. The FMPPI requires that the performance indicator must be verifiable, meaning that it must be possible to validate the processes and systems that produced the indicator. A total of 52% of the indicators were not verifiable. This was due to a lack of proper systems and processes around performance management within the municipality.
35. The FMPPI requires that performance targets should be specific in clearly identifying the nature and required level of performance and must be measurable. A total of 52% of targets were not specific and measurable. This was due to a lack of proper systems and processes around performance management within the municipality.

### Reliability of reported performance information

36. The FMPPI requires auditees to have appropriate systems to collect, collate, verify and store performance information to ensure reliable reporting of actual achievements against planned objectives, indicators and targets. The reported achievements against planned targets of 38% of the indicators were not reliable when compared to the source information or evidence provided.

### **Additional matters**

37. I draw attention to the following matters:

### Achievement of planned targets

38. Refer to the annual performance report on pages x to x for information on the achievement of the planned targets for the year. This information should be considered in the context of the material findings on the usefulness and reliability of the reported performance information in paragraphs 33 to 36 of this report.

### Unaudited supplementary information

39. The supplementary information set out on pages x to x does not form part of the annual performance report and is presented as additional information. I have not audited these schedules and, accordingly, I do not report on them.

### **Compliance with legislation**

40. I performed procedures to obtain evidence that the municipality had complied with applicable legislation regarding financial matters, financial management and other related matters. My material findings on compliance with specific matters in key legislation, as set out in the general notice issued in terms of the PAA, are as follows:

## **Strategic planning and performance management**

41. The adopted integrated development plan (IDP) did not reflect and identify a financial plan, as required by sections 26 and 41 of the MSA, as well as Municipal planning and performance management regulation 2(1)(c).

## **Financial statements**

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

## **Procurement and contract management**

43. Sufficient appropriate audit evidence could not be obtained that all contracts were awarded in accordance with the legislative requirements and a procurement process which is fair, equitable, transparent and competitive, as management could not provide all the bidding documentations for audit purposes.
44. Goods and services with a transaction value of below R200 000 were procured without obtaining the required price quotations as required by SCM regulation 17(a) and (c).
45. Goods and services of a transaction value above R200 000 were procured without inviting competitive bids, as required by SCM regulation 19(a). Deviations were approved by the accounting officer even though it was not impractical to invite competitive bids, in contravention of SCM regulation 36(1).
46. Bid adjudication committees were not always composed in accordance with SCM regulation 29(2).
47. Contracts were awarded to bidders who did not submit a declaration on whether they are employed by the state or connected to any person employed by the state, as required by SCM regulation 13(c).
48. Contracts were awarded to providers whose tax matters had not been declared by the South African Revenue Service to be in order, in contravention of SCM regulation 43.
49. Contracts were extended / modified without tabling the reasons for the proposed amendment in the council of the municipality, as required by section 116(3) of the MFMA.
50. Contracts were extended or modified without the approval of a properly delegated official, in contravention of SCM regulation 5.
51. The contract performance and monitoring measures and methods were insufficient to ensure effective contract management, as required by section 116(2) (c) of the MFMA.



## **Revenue Management**

52. An adequate management, accounting and information system which accounts for debtors was not in place, as required by section 64(2)(e) of the Municipal Finance Management Act.
53. An effective system of internal control for debtors was not in place, as required by section 64(2)(f) of the Municipal Finance Management Act.

## **Expenditure management**

54. Money owed by the municipality was not always paid within 30 days or an agreed period, as required by section 65(2)(e) of the Municipal Finance Management Act.
55. Reasonable steps were not taken to prevent unauthorised expenditure, irregular expenditure and fruitless and wasteful expenditure, as required by section 62(1)(d) of the Municipal Finance Management Act.
56. An adequate management, accounting and information system was not in place which accounted for creditors, as required by section 65(2)(b) of the MFMA

## **Asset management**

57. An effective system of internal control for assets was not in place, as required by section 63(2)(c) of the MFMA.

## **Human resource management and compensation**

58. An approved staff establishment was not in place, as required by section 66(1)(a) of the MSA.
59. The municipal manager and senior managers directly accountable to the municipal manager did not sign performance agreements, as required by section 57(2)(a) MSA.
60. Sufficient appropriate audit evidence could not be obtained that newly appointed manager directly accountable to the municipal manager submitted disclosure of financial interests prior to appointment as per the requirements of regulation 4 of GNR 805.

## **Liability management**

61. An adequate management, accounting and information system which accounts for liabilities was not in place, as required by section 63(2) (a) of the MFMA.
62. An effective system of internal control for liabilities was not in place, as required by section 63(2) (c) of the MFMA.

## **Consequence management**

63. Unauthorised , Irregular, fruitless and wasteful expenditure incurred by the municipality was not investigated to determine if any person is liable for the expenditure, as required by section 32(2)(a)(ii) of the Municipal Finance Management Act.

## **Internal control**

64. I considered internal control relevant to my audit of the financial statements, annual performance report and compliance with legislation. The matters reported below are limited to the significant internal control deficiencies that resulted in the basis for qualified opinion, the findings on the annual performance report and the findings on compliance with legislation included in this report.

## **Leadership**

65. There were a number of top and middle management positions that were vacant for extended periods of time. The continued absence of permanent officials to lead and guide the municipality compromised the effectiveness of the control environment.
66. The leadership did not institute all the disciplines necessary to enable effective oversight that promoted efficiency and effectiveness in financial management, service delivery reporting and compliance with laws and regulations, thus not setting the correct tone for the credibility of all reports generated by the administration. This was evidenced by the material findings on the financial statements, annual performance information and compliance with laws and regulations.

## **Financial and performance management**

67. The annual performance report was not supported by complete, relevant and accurate information. Records management was inadequate and not systematically and regularly monitored by management to ensure that information was easily retrievable and available for audit purposes.
68. The municipality did not have adequate systems in place to monitor compliance with all applicable legislation. As a result, material findings could not be prevented.

## **Governance**

69. The municipality did not implement adequate risk assessment procedures and processes in a timely manner.
70. Internal audit did not function effectively during the financial year. Reports were not issued regularly throughout the year resulting in insufficient time for their recommendations to be adequately implemented by management. The effectiveness of the audit committee was also impaired by the inadequate functioning of the internal audit unit.

## Other reports

71. I draw attention to the following engagements that could potentially impact on the municipality's financial, performance and compliance related matters. My opinion is not modified in respect of these engagements that are either in progress or have been completed.

## Investigations

72. An independent consulting firm performed a forensic investigation on the municipality's payroll at the request of the municipality, which covered the 2014 and 2015 financial years. The investigation was initiated based on an allegation of possible misappropriation of the municipality's assets. The investigation concluded on 8 April 2016. There is no evidence of any further action taken with regards to this report at the date of signing this report.

*Auditor-General*

East London

30 November 2016



AUDITOR - GENERAL  
SOUTH AFRICA

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