

**AUDITOR'S REPORT OF THE AUDITOR-GENERAL TO THE FREE STATE LEGISLATURE
AND THE COUNCIL ON THE MASILONYANA LOCAL MUNICIPALITY FOR THE YEAR
ENDED 30 JUNE 2010**

REPORT ON THE FINANCIAL STATEMENTS

Introduction

1. I was engaged to audit the accompanying financial statements of Masilonyana Local Municipality, which comprise the statement of financial position as at 30 June 2010, 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 and the accounting authority's report as set out on pages ~~xx~~ to ~~xx~~.

Accounting authority's responsibility for the financial statements

2. The accounting authority is responsible for the preparation and fair presentation of these financial statements in accordance with the South African Standards of Generally Recognised Accounting Standards (GRAP) and in the manner required by the Municipal Finance Management Act of South Africa, 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; and making accounting estimates that are reasonable in the circumstances.

Auditor-General's responsibility

3. As required by section 188 of the Constitution of South Africa, 1996 (Act No. 108 of 1996) and section 4 of the Public Audit Act of South Africa, 2004 (Act No. 25 of 2004) (PAA) and section 126(3) of the MFMA my responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with the International Standards on Auditing and *General Notice 1570 of 2009* issued in *Government Gazette 32758 of 27 November 2009*. Because of the matters described in the Basis for disclaimer of opinion paragraphs, however, I was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for disclaimer of opinion

Cash and cash equivalents

4. There were numerous reconciling transactions to the value of R600 354 on the year-end bank reconciliation. A difference amounting to R712 702 was also identified between the reconciled balance and the cash book balance. It could not be determined to which accounts these transactions should have been corrected. Sufficient appropriate audit evidence in respect of debit and credit journals amounting to R41 986 227 and R1 931 601 (2008: R57 341 049), respectively, processed in the bank ledger account during the 2009 financial year could also not be obtained. The records of the municipality did not permit me to perform reasonable alternative procedures regarding these transactions. Consequently, I did not obtain all the information and explanations I considered necessary to satisfy myself as to the completeness and valuation of the bank balance of R203 125 (2009: overdraft of R5 225 804) as disclosed as part of cash and cash equivalents in the statement of financial position.

Property, plant and equipment

5. The location plan detail regarding sewerage, water and electricity networks as well as bucket eradication could not be submitted. Various assets were also found in the asset register with incomplete descriptions / locations. The existence, valuation, rights and obligation of these assets amounting to R330 061 477 as disclosed in note 2 to the financial statements could therefore not be confirmed. The municipality's records did not permit the application of alternative audit procedures.
6. Assets of the municipality to an estimated value of R18 454, located at the municipal premises, could not be found on the asset register, due to assets included in the asset register with incomplete descriptions/locations. Property, plant and equipment are therefore understated by R18 454 and accumulated surplus/(deficit) understated by the said amount.
7. Assets to the value of R34 696 300 were duplicated in the fixed asset register, due to erven included twice. Property, plant and equipment are therefore overstated by R34 696 300 and accumulated surplus/(deficit) overstated by the said amount.
8. There is a difference of R2 314 726 between the amount of assets disclosed in note 2 to the financial statements and the asset register, due to a journal processed in the prior year. Property, plant and equipment are therefore overstated by R2 314 726 and accumulated surplus/(deficit) overstated by the said amount.

Receivables

9. An explanation could not be obtained for the difference of R3 107 044 between the general ledger account and the age analysis for accounts receivable. Individual debtor balances of R225 434 were also identified from the age analysis that did not agree to the debtors subledger. Payments were not made after year-end for debtors amounting to R90 295 710 and no other supporting documentation could also be obtained to confirm the existence of these debtors. Sufficient supporting documentation for sundry debtors to the value of R1 295 456 could also not be obtained. The existence, valuation and the municipality's rights to receivables amounting to R148 631 291 (2009: suspense debtors of R3 062 064) as disclosed in note 6 to the financial statements could therefore not be confirmed. The entity's records did not permit the application of alternative audit procedures regarding receivables.
10. A provision for bad debts amounting to R145 120 993 was disclosed in note 6 to the financial statements. The basis used by the municipality for determining this provision could not be obtained. No bad debts were written off during the financial year. As an alternative procedure a recalculation of the provision was done. The provision for bad debt should have been R90 295 710. The provision for bad debts is thus overstated by R54 825 283 and expenditure is overstated by the said amount.
11. Debtors with credit balances amounting to R7 765 437 (2009: R3 964 769) were included in receivables disclosed in note 6 to the financial statements. These credit balances should have been disclosed as payables in the statement of financial position. Out of these credits an amount of R208 417 could not be verified. Receivables are therefore understated by R7 765 437 and payables by the said amount.

Payables

12. Supporting documentation for a sundry creditor of R26 130 047 as disclosed in note 13 of the financial statements (2009: R47 586 436) could not be provided. The entity's records did not permit the application of alternative audit procedures. Consequently, I could not confirm the existence, valuation and the municipality's obligation of the suspense creditors included in note 13 to the financial statements.
13. I was unable to obtain sufficient appropriate audit evidence as to the completeness, existence, valuation and the municipality's obligation in respect of trade payables of R31 701 318 (2009: R10 798 361) disclosed in the statement of financial position and included in note 14 to the financial statements. Differences were identified between the general ledger and the creditors' sub-ledger. The difference is mainly due to journals without supporting documentation as processed during the 2009 financial year amounting to R4 406 038. Supporting documentation could also not be obtained for journals and differences between the creditors statements and the balances per the creditors list amounting to R2 588 331. The municipality's records did not permit the application of reasonable alternative procedures in respect of these payables.
14. As indicated in note 14 to the financial statements, liabilities relating to this financial year amounting to R2 171 335 (2009: R9 694 935) were identified that were not recorded. This was mainly due to a lack of internal controls to effectively manage creditors and the fact that proper reconciliations were not done. Trade and other payables are therefore understated by R2171 335 and by the said amount.
15. The International Accounting Standards, IAS 39, *Financial Instruments: Recognition and Measurement*, states that loans and receivables shall be measured at amortised cost using the effective interest rate method. As indicated in note 14 to the financial statements, payables of R50 353 403 were not discounted. The records of the municipality did not permit me to perform reasonable calculations in respect of the possible effect of this non-compliance with the accounting framework.

Revenue

Indigents

16. No or incomplete application forms could be obtained to authenticate the amount of R6 525 929 for indigents subsidy as deducted from service charges of R36 480 291 as disclosed in note 16 to the financial statements. The municipality's records did not permit the application of alternative audit procedures. Consequently, I did not obtain all the information and explanations I considered necessary to satisfy myself as to revenue and receivables.

Expenditure

17. Supporting documentation could not be obtained for expenditure of R14 798 101 (2008: R2 166 425), consequently I could not confirm the occurrence, accuracy and classification of this expenditure as disclosed in the statement of financial performance. The municipality's records did not permit the application of reasonable alternative procedures in respect of these transactions.
18. The Standards of Generally Recognised Accounting Practice, GRAP 1, *Presentation of Financial Statements*, states that accrual basis means a basis of accounting under which transactions and other events are recognised when they occur (and not only when cash or

its equivalent is received or paid). As indicated in the statement of financial performance, expenditure relating to the previous financial year was recognised in the current financial year. Expenditure for the current financial year is therefore overstated by R1 760 973 and unspent conditional grants and receipts as recognised in the statement of financial position overstated by the said amount. The comparative expenditure figure is also understated by R1 760 973 and unspent conditional grants and receipts understated by the said amount.

Employee cost

19. The net pay as per the salary run does not agree with the amount as paid out per the bank statements amounting to R915 012. Employee-related cost is therefore overstated by R915 012 and receivables understated by the said amount.
20. Incorrect annual salaries were used to calculate the provision for bonuses. Employee-related expenditure is therefore understated by R637 352 and payables understated by the said amount.
21. Supporting documentation could not be obtained for allowances amounting to R606 933. Supporting documentation could also not be obtained for bulk payments paid to third parties amounting to R5 562 062 and control account balances relating to employee cost amounting to R2 198 698. The municipality's records did not permit the application of reasonable alternative procedures regarding these transactions. Consequently, I did not obtain all the information and explanations I considered necessary to satisfy myself as to the accuracy and occurrence of these transactions.

Inventory

22. Due to the following discrepancies, the completeness, existence, rights and obligations of inventory of R379 356 (2009: R84 360) as disclosed in note 5 to the financial statements could not be confirmed:
 - A proper inventory system for the recording of purchases of fuel, chemicals and uniforms during the financial year did not exist.
 - No basis for the issuing of these inventories could be found. No stands are included in the stock records.
 - No supporting documentation could be obtained for a journal of R294 996 which was recorded to correct the inventory balance.

The municipality's records did not permit the application of reasonable alternative procedures in respect of this inventory balance.

Unspent conditional grants

23. Grants received during the current financial year amounting to R23 747 367 were not recorded in the unspent conditional grants and receipts account. Unspent conditional grants and receipts are therefore understated by R23 747 367, unknown account understated/overstated by R23 747 367.
24. Adequate supporting documentation to confirm authorisation of grant expenditure of R4 471 611 could not be obtained. I could therefore not obtain the necessary information and explanations to satisfy myself as to the occurrence of transactions relating to grant expenditure. The municipality's records did not permit the application of reasonable alternative procedures.

Value-added tax (VAT)

25. The completeness, valuation, rights and obligations of the VAT balance of R11 575 273 (2009: R4 367 073) as disclosed in note 15 to the financial statements could not be confirmed due to the following:
- No VAT reconciliations were performed for the current or previous financial year to substantiate journals processed. A claim was submitted to SARS for a refund on VAT amounting to R1 921 756. This amount was calculated by a consulting company who was remunerated based on refunds. This amount was not properly reviewed and reconciled by management and supporting documentation could only be provided for an amount of R509 199. The difference amounting to R1 412 557 could not be substantiated. The completeness and accuracy of VAT returns could also not be confirmed. The municipality's records did not permit the application of reasonable alternative procedures.
 - Various instances were also identified where VAT was claimed from suppliers not registered for VAT amounting to R637 462. There are no internal controls in place to ensure that a supplier is registered for VAT, before VAT is claimed back from SARS. VAT payable is therefore understated by R637 462 and expenditure understated by the said amount.

Employee benefits

26. The International Accounting Standards, IAS 19 (AC116) *Employee benefits*, outlines the recognition and disclosure requirements pertaining to post-employee benefit plans. Contrary to these requirements, the municipality did not account for its post-employment benefit plans in its financial statements in accordance with IAS19.
- In the absence of actuarial valuations for the pension fund, I was unable to confirm the valuation of the liability and could consequently not determine the effect on the other account balances, classes of transactions and disclosures in the financial statements.
 - Contrary to the requirements of IAS 19 paragraph 44, the amount of R4 811 830 for cost-employee medical benefits was included in the statement of financial position as provisions. This should have been disclosed as an accrued expense as part of trade payables. Provisions are therefore overstated by R4 811 830 and payables understated by the said amount.
 - Contrary to the requirements of ISA 19 paragraph 46, the accrual of R4 811 830 should not be an expense in the statement of financial performance, but should be a prior year adjustment. Expenditure is therefore overstated by R4 811 830 and accumulated surplus/(deficit) overstated by the said amount.
 - The amount of R9 384 292 disclosed in note 21 to the financial statements should have been disclosed separately for the different benefits.

Remuneration of senior management

27. The Municipal Finance Management Act of South Africa, 2003 (Act No. 56 of 2003) (MFMA) section 124(1)(c) states that the notes to the annual financial statements of municipality must include particulars of the salaries, allowances and benefits of every senior manager and such categories of other officials as may be prescribed. Contrary to this requirement, the municipality did not disclose the salaries, allowances and benefits of

senior management in the disclosure notes of the financial statements. The municipality's records did not permit the quantification of the amount that should have been disclosed. The balance as disclosed for the prior year was understated by R855 021.

28. Councillors' remuneration as disclosed in note 22 to the financial statements is overstated by R759 136. The supporting documentation provided indicate an amount of R4 085 271 and not R4 844 407 as disclosed in the financial statements.

Cash flow statement

29. I was unable to confirm an amount of R15 305 042 disclosed in the cash flow statement for the corresponding year and referred to as GRAP conversion related. The municipality's records did not permit the application of alternative audit procedures. Consequently, I did not obtain all the information and explanations I considered necessary to satisfy myself as to the fair presentation of the cash flow statement disclosed in the annual financial statements.

Capital commitments

30. I was unable to obtain sufficient appropriate audit evidence to confirm the existence, valuation, right and obligations of the unspent portion of contracts included in capital commitments to the value of R73 711 466 (2009: R39 052 694) as disclosed in note 29 to the financial statements. The prior year comparative figure was omitted from the financial statements. Contracts could not be obtained for a contract value of R38 387 014. Signed contracts could not be obtained for a contract value of R58 535 717. The records of the municipality did not permit me to perform reasonable alternative procedures in respect of this balance. Consequently, I did not obtain all the information and explanation I considered necessary to satisfy myself as to the existence, valuation, rights and obligations of capital commitments.

Contingent liabilities

31. The Municipal Finance Management Act of South Africa, 2003 (Act No. 56 of 2003) (MFMA) section 125(2)(c) states that the notes to the financial statements of a municipality must include particulars of any contingent liabilities of the municipality as at the end of the financial year. Contingent liabilities amounting to R2 709 742 were identified which were not disclosed in note 33 to the financial statements. Contingent liabilities are therefore understated by R2 708 742.

Fruitless and wasteful expenditure

32. I was unable to obtain sufficient, appropriate audit evidence that management has properly identified, investigated and recorded all fruitless and wasteful expenditure transactions in note 36.2 to the financial statements. The municipality's records did not permit the application of alternative audit procedures. Consequently, I did not obtain all the information and explanations I considered necessary to satisfy myself as to the completeness of fruitless and wasteful expenditure as disclosed in the financial statements.

Opinion

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

Emphasis of matter

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

Going concern

35. As disclosed in accounting policies to the financial statements the municipality indicated that they might experience challenges over the next 12 months to meet some of its obligations. These conditions, along with other matters, point to the existence of a material uncertainty that might cast significant doubt on the municipality's ability to continue as a going concern.

Unauthorised, irregular and fruitless and wasteful expenditure

36. As disclosed in note 36.1 to the financial statements, the municipality incurred unauthorised expenditure of R653 490 (30 June 2009: R0) during the year under review due to inadequate budgetary control measures.

37. As disclosed in note 36.2 to the financial statements, the municipality incurred fruitless and wasteful expenditure of R2 952 700 (30 June 2009: R1 382 839) during the year under review due to the municipality's inability to pay their creditors on time.

38. As disclosed in note 36.3 to the financial statements, the municipality incurred irregular expenditure of R22 555 263 (30 June 2009: R5 693 362) during the year under review due to inadequate procurement processes followed.

Restatement of corresponding figures

39. As disclosed in notes 32 and 33 to the financial statements, the corresponding figures for 30 June have been restated as a result of correcting prior year audit findings during the current financial year in the financial statements of the Masilonyana Local Municipality at, and for the year ended, 30 June 2009.

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

40. As required by the PAA and in terms of *General Notice 1570 of 2009* issued in *Government Gazette 32758 of 27 November 2009*, I include below my findings on the report on predetermined objectives, compliance with the following key laws and regulations, and financial management (internal control):

- MFMA
- Municipal Asset Transfer Regulations, GNR.878 of 22 August 2010 (MATR)
- Division of Revenue Act, 2009 (Act No. 12 of 2009) (DoRA)
- Other enabling legislation:
 - Municipal Systems Act, 2000 (Act No. 32 of 2000) (MSA)
 - Municipal Structures Act, 1998 (Act No. 117 of 1998)

Predetermined objectives

41. Material findings on the report on predetermined objectives, as set out on pages xx to xx, are reported below:

Non-compliance with regulatory and reporting requirements

Non-compliance with regulatory requirements

42. Contrary to the requirements of section 69(3) of the MFMA, the accounting officer did not submit a draft service delivery and budget implementation plan to the mayor within 14 days after the approval of the annual budget.
43. Contrary to the requirements of section 72(1)(a) of the MFMA, in the mid-year performance report, management did not report on the past year's annual report and progress on resolving problems identified in the annual report.
44. Proof could also not be obtained that the mid-year performance report was submitted to the National Treasury and the provincial treasury as required by section 72(1)(b) of the MFMA.
45. Proof could not be obtained that the municipality's integrated development plan was submitted within 10 days of the adoption thereof to the MEC for Local Government in the province as required by section 32(1)(a) of the MSA.
46. Proof could not be obtained that a performance management system was adopted by the municipality as required by regulation 8 of the Municipal Planning and Performance Regulations, 2001, and, therefore, the municipality has not monitored performance and measured and reviewed the performance of each development priorities and objectives against the key performance indicators and targets as required by section 41(1)(c) of the MSA.
47. Proof could not be obtained of any community participation relating to development, implementation and review of the municipality's performance management system, and, in particular, allow the community to participate in the setting of appropriate key performance indicators and performance targets for the municipality as required by section 42 of the MSA, read with regulation 15 of the Municipal Planning and Performance Regulations, 2001.

Timeliness of reported performance information

48. The municipality did not prepare a performance report reflecting the performance of the municipality during the financial year, a comparison of the performances with targets set and performances in the previous year and measures taken to improve performance as required by section 46(1) of the MSA.

Usefulness of reported performance information

49. The following criteria were used to assess the usefulness of the planned and reported performance:
 - Consistency: Has the municipality reported on its performance with regard to its objectives, indicators and targets in its approved integrated development plan, i.e. are the objectives, indicators and targets consistent between planning and reporting documents?
 - Relevance: Is there a clear and logical link between the objectives, outcomes, outputs, indicators and performance targets?

- **Measurability:** Are objectives made measurable by means of indicators and targets? Are indicators well defined and verifiable, and are targets specific, measurable and time bound?

The following audit findings relate to the above criteria:

Planned performance targets not specific, measurable and time bound

50. For the selected department infrastructure, all the planned performance targets in the integrated development plan were set as percentages but the performance targets were not:
- specific in clearly identifying the nature and the required level of performance
 - measurable in identifying the required performance
 - time bound in specifying the time period or deadline for delivery.

Compliance with laws and regulations

MFMA

The accounting officer and municipal entity officials did not adhere to their statutory responsibilities

51. Contrary to numerous SCM Regulations, procurement procedures were not followed as required for the obtaining of quotations, information on, and declarations from, suppliers, etc.

Expenditure was not paid within the parameters set by the applicable legislation

52. Contrary to the requirements as set out in section 65(2)(e) of the MFMA, expenditure amounting to R5 018 805 was not paid within 30 days from the receipt of invoice.

The internal audit unit was not established

53. Contrary to the requirements set out in section 165(1) of the MFMA the municipality did not have an internal audit function for the financial year.

The audit committee was not established

54. Contrary to the requirements set out in section 166 of the MFMA the municipality did not have an audit committee for the financial year.

No performance contracts

55. Contrary to the requirements set out in section 57 of the MFMA the municipality did not enter into performance contracts with management.

INTERNAL CONTROL

56. I considered internal control relevant to my audit of the financial statements and the report on predetermined objectives as well as compliance with the following key legislation: MFMA, MSA and DoRA, but not for the purpose of expressing an opinion on the effectiveness of internal control.

57. The matters reported below are limited to the significant deficiencies regarding the basis for disclaimer of opinion paragraphs, the findings on the report on predetermined objectives and the findings on compliance with laws and regulations.

Leadership

58. The accounting officer did not exercise oversight responsibility over reporting and compliance with laws and regulations and internal control. Accountability to the public is not emphasised.

Financial and performance management

59. Management and staff did not fulfil all their duties and responsibilities pertaining to financial and performance management. Systems were not appropriate to facilitate the preparation of the financial statements and performance reports.

Governance

60. The entity does not identify risks relating to the achievement of financial and performance reporting objectives. An audit committee was not functioning during the year under review. Ongoing monitoring and supervision was not undertaken to enable an assessment of the effectiveness of internal control over financial and performance reporting.

OTHER REPORTS

No other reports were tabled.

Auditor-General

Bloemfontein

30 May 2011



AUDITOR - GENERAL
SOUTH AFRICA

Auditing to build public confidence