

REPORT OF THE AUDITOR-GENERAL TO THE FREE STATE PROVINCIAL LEGISLATURE AND THE COUNCIL ON SETSOTO LOCAL MUNICIPALITY

REPORT ON THE FINANCIAL STATEMENTS

Introduction

1. I have audited the financial statements of the Setsoto Local Municipality 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 the 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 Local Government: Municipal Finance Management Act of South Africa, 2003 (Act No. 56 of 2003) (MFMA) and the Division of Revenue Act of South Africa, 2011 (Act No. 6 of 2011) (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 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. 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 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. 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

6. I was unable to obtain sufficient appropriate audit evidence that management had properly accounted for all items of other property, plant and equipment because items could not be traced to the fixed asset register due to lack of unique asset numbers allocated to individual assets. I was unable to trace these items to the fixed asset register by alternative means. Consequently, I was unable to determine whether any adjustment to other property, plant and equipment stated at R6 485 118 in note 11 of the financial statements was necessary.
7. The municipality did not perform any calculations to determine whether assets identified as having undergone impairment are stated at the lower of its carrying value or its recoverable amount in accordance with Standards of Generally Recognised Accounting Practice, GRAP 21, *Impairment of non-cash generating assets* and GRAP 26, *Impairment of cash generating assets*. Property, plant and equipment, heritage assets and investment property with a carrying value of R696 923 005 are included in the financial statements, but have been identified as having incurred impairment, with no estimation of their recoverable amounts. I was not able to determine the full extent of the understatement of the impairment loss and overstatement of property, plant and equipment as it was impractical to do so.
8. I was unable to obtain sufficient appropriate audit evidence that management had properly accounted for all items of infrastructure assets because 2 116 items were introduced to the fixed asset register with the final submission of the financial statements. Consequently, I was unable to determine whether any adjustment to infrastructure assets stated at R1 972 573 878 (2011:R2 086 317 950) in the financial statements was necessary.

Investment property

9. The municipality did not recognise all property held for capital appreciation or for a future undeterminable use as investment property in accordance with Standards of Generally Recognised Accounting Practice, GRAP 16, *Investment property*. Consequently, investment property is understated by R23 109 500 (2011:R23 109 500) and property plant and equipment is overstated by the same amount.

Inventory

10. The municipality did not recognise all land held for sale as inventory in accordance with Standards of Generally Recognised Accounting Practice, GRAP 12, *Inventories*. Consequently, inventory is understated by R2 311 000 (2011:R2 311 000) and property plant and equipment is overstated by the same amount.

Trade and other receivables from exchange transactions

11. I was unable to obtain sufficient appropriate audit evidence for all other trade and other receivables from exchange transactions as no supporting records could be obtained. I was unable to confirm these balances by alternative means. Consequently, I was unable to determine whether any adjustment to other trade receivables from exchange transactions, stated at R23 770 615 (2011; R19 749 473) before provision of R20 066 990 (2011: R11 262 471) in note 5 of the financial statements, was necessary. Furthermore, relevant information was not available for all indigents. Consequently, I was unable to determine whether any adjustment to trade receivables from exchange transactions, stated at R311 936 678 before provision for impairment of 245 428 444 in note 5 of the financial statements, was necessary.

12. Several debtors' accounts contain incorrect year-end balances due to incorrect readings that were not detected and corrected before year-end. Consequently, revenue and trade and other receivables from exchange transactions are understated by a projected amount of R7 759 835. Consequently, there is an impact on the deficit for the period and the accumulated surplus.

Other receivables from non-exchange transactions

13. I was unable to obtain sufficient appropriate audit evidence for certain sundry debtors as included in other receivables from non-exchange transactions as supporting records for all sundry debtors were not available. I was unable to confirm these other receivables from non-exchange transaction by alternative means. Consequently, I was unable to determine whether any adjustment to other receivables from non-exchange transactions stated at R2 385 567 in note 6 of the financial statements was necessary.

Revenue

14. I was unable to obtain sufficient appropriate audit evidence for revenue as the municipality did not ensure that correct tariffs for sewerage and refuse were used on all consumer accounts, while differences between source records and consumer accounts occurred for water and electricity consumption. In addition, interest was levied on incorrect balances. Furthermore, proper control records, internal checking and reconciliations were not done or kept for other income relating to the caravan park, the renting of halls, traffic income, connection fees, building plan fees and refuse removals. Due to this, as well as the lack of sufficient supporting documentation for revenue journals, I was unable to determine whether any adjustment to revenue stated at R402 163 352 in the financial statements was necessary.

Employee related cost

15. I was unable to obtain sufficient appropriate audit evidence for employee-related cost as supporting documentation for certain employee-related expenses and journals processed could not be obtained. I was unable to confirm the employee-related cost transactions by alternative means. Consequently, I was unable to determine whether any adjustment to employee-related cost stated at R91 547 012 in the financial statements was necessary.

Employee benefit obligation

16. The municipality did not measure its post-employment benefit obligation in accordance with South African Statement of Generally Accepted Accounting Practice, IAS 19 *Employee benefits*. In the absence of an actuarial valuation, I was unable to determine the obligation that should have been disclosed in the financial statements. Consequently, there is an impact on the deficit for the period and the accumulated surplus.

Expenses

17. During the 2010-11 audit, I was unable to obtain sufficient appropriate audit evidence regarding operating expenditure. I was unable to confirm the expenditure by alternative means. Consequently, I was unable to determine whether any adjustment to operating expenditure for the prior year stated at R47 134 617 was necessary. My audit opinion on the financial statements for the period ended 30 June 2011 was modified accordingly. My opinion on the current period's financial statements is also modified because of the possible effect of this matter on the comparability of the current period's figures.

18. I was unable to obtain sufficient appropriate audit evidence for journal transactions as supporting evidence for journal transactions processed could not be submitted. I was unable to confirm the journal transactions by alternative means. Consequently, I was unable to determine whether any adjustment to expenses stated at R461 954 714 in the financial statements was necessary.

Trade and other payables from exchange transactions

19. I was unable to obtain sufficient appropriate audit evidence for payments received in advance from trade receivables disclosed as other payables from exchange transactions. These debtor accounts in credit could not be confirmed as numerous accounts contain error transactions that were not detected and corrected before year-end. I was unable to confirm these trade and other payables from exchange transactions by alternative means. Consequently, I was unable to determine whether any adjustment to trade and other payables from exchange transactions regarding payments received in advance of R6 744 651 stated in note 15 to the financial statements was necessary.

Cash flow statement

20. The cash flow statement and the related notes are not fairly stated due to the material effect on the cash flow statement and related notes of scope limitations identified and as reported in this report. An amount of R9 181 901 (2011: R4 336 032) was incorrectly disclosed as income from investments and not as cash and cash equivalents.

Investments in municipal entity

21. The financial statements of the municipality could be misstated as the financial information of the municipal entity established by the council during the prior financial year, namely the Setsoto Integrated Dairy Project, was not consolidated and a consolidated set of financial statements was not presented for auditing, as required by section 126(1)(b) of the MFMA.

Aggregation of immaterial uncorrected misstatements

22. The financial statements as a whole are materially misstated due to the cumulative effect of numerous individually immaterial uncorrected misstatements in the following elements making up the statement of financial position and the statement of financial performance:

- Service charges reflected as R101 681 034 are overstated by R666 511
- Employee-related cost reflected as R91 547 012 is understated by R344 775
- General expenses reflected as R42 354 085 are overstated by R66 405
- Cash and cash equivalents reflected as R6 791 111 are overstated by R43 062.

Qualified opinion

23. 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 Setsoto Municipality as at 30 June 2012, its financial performance and cash flows for the year then ended, in accordance with GRAP, MFMA and DoRA.

Emphasis of matters

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

Restatement of corresponding figures

25. As disclosed in note 52 to the financial statements, the corresponding figures for 30 June 2011 have been restated as a result of errors discovered during the current financial year in the financial statements of the Setsoto Local Municipality at, and for the year ended, 30 June 2011.

Material losses and impairments

26. As disclosed in note 5 to the financial statements, material losses of R19 106 140 (2011: R1 640 587) were incurred as a result of the write-off of irrecoverable trade debtors (debt impairment).
27. As disclosed in note 44 to the financial statements, material losses of R13 106 733 (2011: R13 798 074) and R 20 853 869 (2011: R6 368 567) were incurred as a result of the write-off of distribution losses relating to water and electricity, respectively.

Additional matters

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

Supplementary explanations of budget variances presented outside the financial statements

29. The supplementary explanations of budget variances contained in appendix E do not form part of the financial statements. I have not audited these explanations and, accordingly, I do not express an opinion thereon.

Unaudited supplementary schedule

30. The supplementary information set out on pages 79 to 86 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

31. 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

32. We performed procedures to obtain evidence about the usefulness and reliability of the information in the annual performance report as set out on pages xx to xx of the annual report.
33. The reported performance against predetermined objectives was evaluated against the overall criteria of usefulness and reliability. The usefulness of information in the annual

performance report relates to whether it is presented in accordance with the National Treasury's annual reporting principles and whether the reported performance is consistent with the planned development priorities. The usefulness of information further relates to whether 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*.

34. The reliability of the information in respect of the selected development priority is assessed to determine whether it adequately reflects the facts (i.e. whether it is valid, accurate and complete).

35. The material findings are as follows:

Usefulness of information

Presentation

Measures taken to improve performance not disclosed

36. Improvement measures in the annual performance report for a total of 79% of the planned targets not achieved were not disclosed as required by section 46 of the Municipal Systems Act, 2000 (Act No. 32 of 2000) (MSA). This was due to inadequate internal policies and procedures in respect of the processes pertaining to the reporting of performance information.

Consistency

Reported objectives, indicators, targets not consistent with planned objectives, indicators, targets

37. Section 41(c) of the MSA requires that the integrated development plan should form the basis for the annual report, therefore requiring consistency of objectives, indicators and targets between planning and reporting documents. None of the planned objectives (100%) as per the approved integrated development plan are stated in the annual performance report. A total of 77% of the reported indicators are not consistent with the indicators as per the approved integrated development plan, while a total of 85% of the reported targets are not consistent with the targets as per the approved integrated development plan. This is due to a service delivery and budget implementation plan (SDBIP) not being compiled and approved by the mayor of the municipality and a lack of monitoring of the completeness of reporting documents by management and the performance audit committee.

Reliability of information

Reported indicators and targets not supported by sufficient appropriate evidence (validity, accuracy and completeness)

38. For 78% of the reported indicators and targets of the selected infrastructure and basic services, I was unable to obtain sufficient, appropriate audit evidence to satisfy myself as to the validity, accuracy and completeness of actual performance in terms of the reported indicators and targets in the annual performance report. This is due to inadequate review processes and reporting, which is an indication of material shortcomings in the processes, systems and procedures followed in the collection, recording, processing and reporting of performance information.

Additional matter

39. I draw attention to the following matter below. This matter does not have an impact on the predetermined objectives audit findings reported above.

Achievement of planned targets

40. Of the total number of planned targets as per the approved integrated development plan, only nine were achieved during the year under review. This represents 81% of the total planned targets that were not achieved during the year under review. This was as a result of the late approval of the performance management policy framework which could not be implemented during the year under review.

Compliance with laws and regulations

41. We performed procedures to obtain evidence that the entity had complied with applicable laws and regulations regarding financial matters, financial management and other related matters. Our 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:

Strategic planning and performance management

42. The municipality did not ensure that the annual objectives and indicators for the municipal entity, Setsoto Integrated Dairy (Pty) Ltd, are established by agreement with the municipal entity and included in the municipal entity's multi-year business plan, as required by section 93C(a)(iv) of the MSA.

43. The performance of Setsoto Integrated Dairy (Pty) Ltd was not monitored and annually reviewed as part of the annual budget process, as required by section 93C(a)(v) of the MSA.

44. The municipality did not establish mechanisms to monitor and review its performance management system, as required by section 40 of the MSA.

Budget

45. Quarterly reports on the implementation of the budget and financial state of affairs of the municipality were not submitted to council within 30 days after the end of each quarter, as required by section 52(d) of the MFMA.

Annual financial statements, performance and annual report

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 of non-current assets, current assets, liabilities, expenditure, revenue, notes and disclosure items identified by the auditors in the submitted financial statements were subsequently corrected by a consulting firm appointed by the municipal manager during the course of the audit to effect extensive corrections to the financial records of the municipality and to compile a new set of financial statements for 2011-12 which was submitted on 20 March 2013. Consolidated annual financial statements were not prepared as required by section 122(2) of the MFMA.

47. The accounting officer did not make the 2010-11 annual report public immediately after the annual report was tabled in the council, as required by section 127(5)(a) of the MFMA.

Expenditure management

48. Reports regarding unauthorised, irregular or fruitless and wasteful expenditure incurred by the municipality were not submitted to the mayor, the MEC for local government and the Auditor-General, as required by section 32(4) of the MFMA.
49. Money owing by the municipality was not always paid within 30 days of receiving an invoice or statement, as required by section 65(2)(e) of the MFMA.
50. The accounting officer did not in all instances take effective steps to prevent unauthorised, irregular or fruitless and wasteful expenditure, as required by section 62(1)(d) of the MFMA.
51. 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 65(2)(a) of the MFMA.
52. An adequate management, accounting and information system which recognised expenditure when it was incurred, accounted for creditors of the municipality and accounted for payments made by the municipality, was not in place as required by section 65(2)(b) of the MFMA.

Revenue management

53. A credit control and debt collection policy was not implemented, as required by section 96(b) of the MSA and section 62(1)(f)(iii) of the MFMA.
54. The municipality contravened section 15(2) of the Electricity Regulatory Act, 2006 (Act No 4 of 2006) by charging electricity tariffs in excess of those approved by the National Electricity Regulator of South Africa.
55. With reference to section 64(3) of the MFMA, proof could not be obtained that the municipality had informed the National Treasury of any payments due by an organ of state to the municipality in respect of municipal tax or for municipal services where payments were regularly in arrears for periods exceeding 30 days.
56. All revenue received by the municipality was not reconciled at least on a weekly basis, as required by section 64(2)(h) of the MFMA.
57. The rates policy was not annually reviewed by council, as required by section 5(1) of the Municipal Property Rates Act, 2004 (Act No. 6 of 2004) (MPRA).
58. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained an effective management, accounting and information system which recognises revenue when it is earned, accounts for debtors and accounts for receipts of revenue, as required by section 64(2)(e) of the MFMA.
59. The municipality did not update its valuation roll for the 2011-12 financial year, as required by section 77 of the MPRA, as no interim valuations were performed.

Asset management

60. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained an adequate management, accounting and information as well as internal control system, including an asset register to account for assets, as required by section 63 (2) of the MFMA. Consultants were contracted in to update the asset register and value the assets in accordance with Standards of Generally Recognised Accounting Practice.

Procurement and contract management

61. Sufficient appropriate audit evidence could not be obtained that goods and services with a transaction value of below R200 000 were procured by obtaining the required price quotations, as required by Supply Chain Management (SCM) regulations 17(a) and (c).
62. 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, which is in contravention of SCM regulation 36(1).
63. Sufficient appropriate audit evidence could not be obtained that bid specifications for procurement of goods and services through competitive bids were drafted in an unbiased manner which allowed all potential suppliers to offer their goods or services, as required by SCM regulation 27(2)(a).
64. Sufficient appropriate audit evidence could not be obtained that bid specifications were drafted by bid specification committees which were composed of one or more officials of the municipality, as required by SCM regulation 27(3).
65. Sufficient appropriate audit evidence could not be obtained that invitations for competitive bidding were advertised for the required minimum period of days, as required by SCM regulation 22(1) and 22(2).
66. Awards were made to bidders other than those recommended by the bid evaluation committee without ratification by the accounting officer, as required by SCM regulation 29(5)(a)(ii) and (b)(ii).
67. Contracts were awarded to bidders based on preference points that were not calculated in accordance with the requirements of the Preferential Procurement Policy Framework Act, 2000 (Act No. 5 of 2000) and its regulations.
68. A list of accredited prospective providers was not in place for procuring goods and services through quotations, as required by SCM regulation 14(1)(a).
69. The prospective providers list for procuring goods and services through quotations was not updated at least quarterly to include new suppliers that qualify for listing, and prospective providers were not invited to apply for such listing at least once a year as per the requirements of SCM regulation 14(1)(a)(ii) and 14(2).
70. Persons in service of the municipality who had a private or business interest in contracts awarded by the municipality failed to disclose such interest, as required by SCM regulation 46(2)(e).
71. The accounting officer did not ensure that the SCM policy was reviewed for the 2011-12 financial year, as required by SCM regulation 3(1) and paragraph 3(1)(a) of the Setsoto Local Municipality's SCM policy.

72. All the councillors did not submit their declaration of interest to the municipality, as required by the code of conduct for councillors in terms of the MSA.

Financial misconduct

73. Sufficient appropriate audit evidence could not be obtained that investigations were instituted into all allegations of financial misconduct against officials of the municipality, as required by section 171(4)(a) of the MFMA due to the fact that, at the time of the audit, not all unauthorised, irregular or fruitless and wasteful expenditure incurred by the municipality was investigated.

Human resource management and compensation

74. The municipal manager and managers directly accountable to the municipal manager did not sign performance agreements, as required by section 57(2)(a) of the MSA.

75. The municipality did not submit a report on compliance with prescribed competency levels to the National Treasury and relevant provincial treasury, as required by regulation 14(2)(a) of the *Regulations on minimum competency levels*.

76. The annual report of the municipality did not reflect information on compliance with prescribed minimum competencies, as required by regulation 14(2)(b) of the *Regulations on minimum competency levels*.

77. The municipality did not establish a performance management system, as required by section 67(d) of the MSA.

Environmental management

78. The municipality operated one waste disposal site without a waste management licence or permit, in contravention of section 20(b) of the National Environmental Management: Waste Act, 2008 (Act No. 59 of 2008) and section 20(1) of the Environmental Conservation Act, 1989 (Act No. 73 of 1989).

Internal control

79. We considered internal control relevant to our audit of the financial statements, the 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 the qualified opinion, the findings on the annual performance report and the findings on compliance with laws and regulations included in this report.

Leadership

80. During the financial year under review, management failed to heed and implement all comments and recommendations made by the auditors in the previous financial year due to the fact that the action plan was not fully implemented.

81. During the financial year under review, leadership did not hold staff of the municipality accountable due to the performance management system not being implemented.

82. During the financial year under review, leadership did not take timeous and adequate action to address weaknesses in the finance and SCM directorates which resulted in non-compliance with applicable legislation and gave rise to unauthorised, irregular or fruitless and wasteful expenditure.

Financial and performance management

83. During the financial year under review, the staff members of the municipality were not sufficiently skilled to ensure that daily financial activities were fully and correctly recorded in the records of the municipality. Management also did not ensure that all transactions and records were internally checked to detect possible fraudulent activities and to correct all errors in the financial records. Furthermore, evidence could not be submitted that monthly bank reconciliations were performed and reviewed by management.
84. During the financial year under review, revenue received was not reviewed and reconciled on a weekly basis. In the absence of proper review of bank reconciliations, differences between receipts and bank deposits were not detected and corrected by management. Unidentified direct bank deposits were also not cleared on a regular basis during the financial year.
85. As a result of inadequate of internal review of transactions, incorrect tariffs for sewerage and refuse as well as differences between source records and water and electricity debtor accounts were not detected and corrected by management.
86. The financial statements submitted for auditing were not supported by a complete audit file. The financial statements and the audit file were not properly reviewed for completeness and accuracy prior to the submission thereof for auditing.
87. The general ledger accounts and the financial statements were subjected to material corrections resulting from the audit process, which are attributable to shortcomings in the design and implementation of internal control in respect of financial reporting as well as shortcomings in the information system of the municipality.
88. During the year under review, the accounting officer did not regularly review and monitor management's compliance with all laws and regulations and internally designed policies and procedures. As a result, significant non-compliance issues were noted that could have been prevented.

Auditor -General

Bloemfontein

30 April 2013



AUDITOR - GENERAL
SOUTH AFRICA

Auditing to build public confidence