

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

REPORT ON THE FINANCIAL STATEMENTS

Introduction

1. I was engaged to audit the accompanying financial statements of Maluti-a-Phofung Water (Pty) Ltd, which comprise the statement of financial position as at 30 June 2011, the statement of financial performance, the statement of changes in net assets and the 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 x 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 South African Standards of Generally Recognised Accounting Practice (SA Standards of GRAP) and in the manner required by the Local Government: Municipal Finance Management Act of South Africa, 2003 (Act No. 56 of 2003) (MFMA) and for such internal control as management determines 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. As required by section 188 of the Constitution of the Republic of South Africa, 1996 (Act No. 108 of 1996), section 4 of the Public Audit Act of South Africa, 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 International Standards on Auditing and *General Notice 1111 of 2010* issued in *Government Gazette 33872* of 15 December 2010. 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.
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. 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 separate financial statements.
6. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my qualified audit opinion.

Basis for qualification opinion

Property, plant and equipment

7. The asset register was deemed the only suitable record of assets held by the entity that supported the property, plant and equipment amounting to R2 401 283 (2010:

R2 761 233) as disclosed in the statement of financial position and note 8 to the financial statements. During the year 1 066 assets were identified that were not previously included in the asset register. These assets were included in the asset register at R1 as the values could not be determined during the financial year. Since the entity's accounting records did not permit the application of reasonable alternative procedures, I was unable to confirm the valuation of property, plant and equipment, as disclosed in the statement of financial position and note 8 to the financial statements for the current and prior year.

8. International Accounting Standard 36, *Impairment of assets*, and International Public Service Accounting Standard 21, *Impairment of non-cash generating assets*, requires that property, plant and equipment should be assessed for impairment at each reporting date. Management did not assess whether there was a decrease in the value of property, plant and equipment. Consequently, I could not obtain adequate audit assurance as to the valuation of property, plant and equipment in note 8 and the cost of impairment in the statement of financial position for the current and prior year.
9. The useful lives used for the depreciation charge for plant and machinery, and office and other equipment differed from the useful lives described in accounting policy note 1.2 to the financial statements. The depreciation charge and accumulated depreciation, disclosed in the statement of financial performance and statement of financial position respectively, are understated in aggregate by R276 684 and property, plant and equipment is overstated by the same amount.

Inventories

10. Paragraph 17 of GRAP 12, *Inventories*, requires all inventories to be recognized at the lower of the cost of the inventories and the net realisable value. Paragraph 18 requires inventories to be shown at replacement value where it would be distributed at no or nominal cost or consumed in the production of goods distributed at no or a nominal cost. I identified 53 inventory items for which the entity carried stock which had no value assigned to it. I was unable to obtain sufficient appropriate audit evidence with regard to the valuation of inventories amounting to R1 973 063, disclosed in the statement of financial position and note 3 to the financial statements, due to this weakness. I could also not perform alternative procedures to confirm this balance due to the lack of information.

Trade and other payables

11. The existence, completeness and valuation of, as well as the entity's obligation towards the balance of trade payables amounting to R5 556 809 (2010: R3 461 823) disclosed in the statement of financial position and note 12 to the financial statements, could not be confirmed due to supplier statements and supporting documentation not obtained. I was not able to perform alternative procedures to confirm this balance.
12. I could also not obtain sufficient appropriate audit evidence for accruals amounting to R864 919 which is included in deposits and disclosed in note 12 to the financial statements to confirm the existence and valuation of, and the entity's obligations to accruals. I was not able to perform alternative procedures to confirm this balance.
13. Unreconciled differences between the financial records and the suppliers' statements were identified in the prior year which indicates that payables to the amount of R445 864 had not been recorded in the financial records. This resulted in an understatement of payables and expenditure as disclosed in the financial statements for the prior year.

Irregular expenditure

14. Irregular expenditure is defined in section 1 of the MFMA as expenditure incurred by the entity in contravention of or not in accordance with the MFMA, the Municipal Systems Act, 2000 (Act No. 32 of 2000), or a requirement of the supply chain management policy

of the entity and must be disclosed in the financial statements in terms of section 125(d) of the MFMA.

The audit revealed irregular expenditure amounting to R3 147 285 that was not disclosed in note 37 to the financial statements. This irregular expenditure related to instances where officials did not comply with the SCM policy of the entity or where the SCM policy was less strict than the requirements of the SCM Regulations which resulted in irregular expenditure. Due to the nature of the matters as well as the deficiencies in the systems of internal control and financial reporting at the entity, I could not confirm the completeness of the amount.

Related parties

15. I could not obtain sufficient appropriate audit evidence to confirm the cut-off, accuracy and completeness of related parties, disclosed in note 31 to the financial statements. This is due to financial declarations not provided to me for all employees. The entity's records did not provide for suitable alternative procedures to be performed.

Qualified opinion paragraph

16. In my opinion, except for the 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 Maluti-a-Phofung Water (Pty) Ltd at 30 June 2011 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 matter

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

Significant uncertainty

17. The entity disclosed a contingent liability amounting to R43 440 960 as part of the balance of R51 432 510 in note 30 to the financial statements. This amount is the difference between the entity's calculated balance and the balance indicated by Department of Water and Environmental Affairs (DWEA) at year-end. The entity disputes the amounts based on invoices for services not rendered to it and the interest charged on the balance under dispute.
18. Should DWEA disallow the writing-off of the disputed amount in total, the entity's current liabilities would exceed its current assets by more than four times and would cast doubt over the entity's ability to be technically solvent in future.

Restatement of corresponding figures

19. Changes were made to corresponding figures and the detail is disclosed in note 32 to the financial statements.

Going concern

20. The basis of preparation paragraph in note 34 to the financial statements indicates that the entity compiled the financial statements on the going concern principle. The entity incurred a net deficit of R7 016 570 (2010: R9 415 471) during the year ended 30 June 2011 and, as of that date, the entity's current liabilities exceeded its total assets by R41 629 575 (2010: R34 613 007). These conditions, along with other matters noted, indicate the existence of a material uncertainty that may cast significant doubt on the entity's ability to operate as a going concern.

Fruitless and wasteful expenditure

21. Fruitless and wasteful expenditure amounting to R403 619 (2010: R319 888) was disclosed in note 36 to the financial statements. This includes interest and penalties on VAT payments amounting to R80 570 and the balance of R319 888 from the prior year.

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

22. In accordance with the PAA and in terms of *General Notice 1111 of 2010*, issued in *Government Gazette 33872 of 15 December 2010*, I include below my findings on the annual performance report as set out on pages to and material non-compliance with laws and regulations applicable to the municipality.

Report on predetermined objectives

Usefulness of information

23. The reported performance information was deficient in respect of the following criteria:

- Consistency: The reported objectives, indicators and targets are not consistent with the approved integrated development plan.
- Relevance: There is no clear and logical link between the objectives, outcomes, outputs, indicators and performance targets.
- Measurability: The indicators are not well defined and/or verifiable, and targets are not specific, measurable, and/or time bound.

24. The following audit findings relate to the above criteria:

- Reported performance against predetermined objectives is not consistent with the approved integrated development plan (IDP).

Key performance areas as per:	
Service delivery agreement	IDP
Staff empowerment	Financial Management
Operation	Institutional Transform
Customer service	Democracy and Governance
Management of municipal revenue collection	Social and Economic Development
Local economic development	None

- The indicator and targets as per the annual performance did not relate directly in more than 80% of instances to the institution's strategic goals and objectives as per the five year integrated development plan/service delivery agreement.
- For the selected objectives, 25% of the planned and reported indicators were not clear, as unambiguous data definitions were not available to allow for data to be collected consistently.
- For the selected objectives, valid performance management processes and systems that produce actual performance against the planned indicators do not exist for 25% of the indicators.

Reliability of information

25. The reported performance information was deficient in respect of the following criteria:

- Validity: The reported performance did not occur and does not pertain to the entity.
- Accuracy: The amounts, numbers and other data relating to reported actual performance have not been recorded and reported appropriately.
- Completeness: All actual results and events that should have been recorded have not been included in the reported performance information.

26. The following audit findings relate to the above criteria:

- For the selected objectives, 67% of measurements to improve performance in the annual performance reports were not supported by adequate and reliable corroborating evidence.
- The integrated development plan did not include the key performance indicators and performance targets determined in accordance with its performance management system, as required by sections 26(i) and 41(1) (b) of the MSA and regulation 12 of the Municipal Planning and Performance Management Regulations, 2001.

Compliance with laws and regulations

Municipal Finance Management Act

Financial statements

27. The financial statements submitted for audit did not comply with section 122 of the MFMA. Material misstatements were identified during the audit, certain of these were corrected by management and those that were not are included in the basis for disclaimer of opinion paragraphs.

Procurement and contract management

28. Goods and services with a transaction value of between R10 000 and R200 000 were procured without obtaining written price quotations from at least three different prospective providers as per the requirements of SCM regulation 17(a) and (c).

29. Goods and services with a transaction value of between R30 000 and R200 000 were procured without obtaining proper tax clearance certificates and not using suppliers registered on the approved suppliers list per the requirements of SCM regulation 16(c)(iii).

30. Goods and services of a transaction value above R200 000 were procured without inviting competitive bids as per the requirements of SCM regulation 19(a).

Expenditure management

31. Payments to various suppliers were not made within 30 days of date of receipt of the relevant invoice or statement, as required by section 99(2)(b) of the MFMA.

32. The accounting officer did not take reasonable steps to prevent irregular expenditure and fruitless and wasteful expenditure, as required by section 95(d) of the MFMA.

Asset management

33. The accounting officer did not take all reasonable steps to ensure that the municipal entity had and maintained an effective system of internal control for assets, including an asset register as required by section 96(2)(b) of the MFMA.

INTERNAL CONTROL

34. I considered internal control relevant to my audit of the financial statements and the report on predetermined objectives and compliance with the MFMA, but not for the purposes of expressing an opinion on the effectiveness of internal control. The matters reported below are limited to the deficiencies identified during the audit.

Leadership

- Management did not exercise oversight responsibility regarding financial and performance reporting and compliance and related internal controls.
- Leadership lacked knowledge on the requirements for financial and performance reporting. A high level of dependence on the financial consultant occurred during the financial reporting period.
- Management did not enforce good governance and accountability, including IT governance, in all instances and this impacted on the practices of staff which undermines the control environment of the entity. This also contributed to the fact that timeous action was not taken on all audit recommendations and this resulted in matters not being resolved timeously.
- The performance reporting of the entity in the annual report also did not adhere to the requirements to ensure that accurate and substantiated performance is reported in the annual report.
- The performance of staff and suppliers were also not properly monitored to ensure that high performance is encouraged.

Financial and performance management

- Finance staff had a general lack of understanding of the GRAP accounting framework and as a result are not compiling regular, accurate and complete financial reports. The annual financial statements were subjected to material changes and were not properly reviewed.
- There was an improvement in the safeguarding and provision of documentation, but the remaining deficiencies did negatively impact on the audit.
- The lack of experience in linking performance to supporting documentation, as well as to link the performance measures to the IDP of the municipality hampered the performance reporting process.
- The lack of implementation and monitoring of controls resulted in non-compliance with laws and regulations and in particular irregular expenditure.

Governance

- The ongoing monitoring of the effectiveness of internal audit were not undertaken as this would have highlighted the lack of management action on the recommendations made by internal audit with regards to the performance information. All internal audits as per the internal audit plan for the year under review could not be completed timeously due to inadequate staff in the internal audit unit.

Auditor-General
Bloemfontein

30 November 2011



AUDITOR-GENERAL
SOUTH AFRICA