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19/06/16

The Mayor
Local Council Sannat
Sannat Road,
Sannat,
Gozo.

Dear Mayor,

RE: MANAGEMENT REPORT FOR THE YEAR ENDED 31 DECEMBER 2015

We have completed our audit of the financial statements of the Local Council Sannat for the year ended 31 December 2015. The purpose of this report is to summarise our principal findings arising from this work.

Our audit was primarily based on verifying balances in the financial statements to ensure that they are free from material error and comply with relevant legislation. Consequently, the matters raised in this report cannot be regarded as a comprehensive statement of all weaknesses that exist or all improvements that might be made. Our aim is to offer guidance to the Local Council such that it would be in a better position to improve its internal controls, enhance its book keeping function and consolidate its overall governance.

Our engagement obliges us to distribute copies of this report to (a) your Council; (b) the National Audit Office; and (c) the Local Councils Department. Consequently this report, may not be distributed, used or quoted, in part or in full except for the scope it is prepared, without our prior written consent.

This report has been prepared on the basis of the limitations set out in the Responsibility Statement as presented on page 11 of this report.

During the course of our audit for the year ended 31 December 2015, we examined the principal documents, systems and controls used by the Council, to help it ensure, as far as possible, the accuracy of these documents and to assess how much can one rely on these documents to safeguard the assets of the Council. We also examined, whether or not your Council abided by the procedures as they are provided for in the Local Councils Act, 1993, the Financial Procedures and various Legal Notices issued to your Council.

The objective of this letter is to bring to your attention those divergences in the system that were noticed during our audit work and suggest ways of how these can be remedied.

We would like to take this opportunity to thank the Executive Secretary and the clerks for their assistance during the course of our audit.

A handwritten signature in blue ink, appearing to read 'Conrad Borg', is written over a horizontal line.

Conrad Borg (Partner)
for and on behalf of
RSM Malta

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Local Council Sannat

Management Report for the year ended 31 December 2015

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1.0 Follow-up to Last Year's Report

1.1 Property, plant and equipment

Last year, several issues were noted with regards to property, plant and equipment including:-

- The fixed assets register did not agree with the financial statements before passing any audit adjustments;
- Errors were found in the calculation of the depreciation for the year;
- Items of property, plant and equipment were not separately identifiable;
- Projects that were completed during the year were still being classified as assets under construction;
- Costs relating to projects completed during the year were not accounted for;
- Certain assets categories were under insured;
- The errors found in previous years of borrowing costs relating to the new Council premises not being capitalised and the depreciation being started before the premises were made available for use were not corrected; and
- An expenditure of a revenue nature was mistakenly capitalised.

These issues were all encountered once again this year except that there were no completed projects still classified as assets under construction.

1.2 Receivables

The recommendation made by us to accrue for income not yet received with respect to projects which were completed by the end of the year, was still not taken by the Council during the year under review.

We also noted that the Local Council was not providing for amounts older than two years as instructed by the Department for Local Government. The necessary provisions were made this year.

1.3 Bank and Cash

Last year we noted that some cheques were issued before being approved by the Council. No such situations were noted during the current year.

When checking the bank reconciliations, it was also noted that the transactions for the year of the bank account for Measure 313 were completely left out. No such situations were noted during the current year.

While testing the petty cash transaction, one instance was found where the limit of Euro 23.29 was exceeded. No such transactions were noted during the current year under review.

1.4 Payables

Last year we pointed out that when projects were either fully completed by the end of the year or otherwise were in progress at the end of the year and no invoices for such works would have been issued by the suppliers, accruals should be accounted for to reflect the liability arising from those works. The same principle applies for goods bought by or services rendered to the Local Council which would not have yet been invoiced. This weakness was not encountered during this year.

Another weakness we highlighted last year was on the amortisation of the deferred income with respect to grants relating to capital projects whereby several errors were found. Similar issues were encountered this year for which we had to pass audit adjustments.

1.5 Income

Last year the Local Council reversed an amount of income that was receivable against the income for the year when such income was not yet received. Certain items of income were posted in the wrong nominal accounts. Errors were also found in the calculation of the amortisation of the deferred income for the year.

Apart from the first weakness which was not found this year, the other two weaknesses were once again encountered.

1.6 Expenditure and Tenders

The Local Council did not draw up purchase requests in line with the Local Councils Financial Procedures. Furthermore, the Council exceeded the budgeted expenditure under various expenditure categories. These weaknesses were once again encountered during this year's audit.

Instances were also encountered last year whereby quotations were not requested for particular expenditure incurred and in one instance, the Local Council was not provided with a VAT fiscal receipt. This year no such instances were encountered.

1.7 Payroll

Last year, the main weaknesses in this area were that variances were found between the different FSS forms, there was a minor error in the computation of one of the salaries, FS4 forms were not prepared, the performance bonus paid to the ex-executive secretary was not included in the FSS forms and the social security contributions of one of the employees were computed incorrectly. These weaknesses were not encountered this year although other weaknesses were found.

1.8 Liquidity

As at 31 December 2014, the current liabilities exceeded the current assets by Euro 18,533 indicating possible liquidity problems. As at the end of the financial year under review, the Local Council had the same situation.

1.9 Financial Situation Indicator

As at 31 December 2014, the financial situation indicator of the Local Council stood at negative 21.8% which fell below the 10% threshold required by the Financial Provisions to the Local Councils Act. As at 31 December 2015, the financial situation indicator was still negative.

2.0 PROPERTY, PLANT AND EQUIPMENT

- 2.1 No fixed assets register was provided to us by the Council during the audit as it has not been updated. Kindly note that the cost of the Local Council's property, plant and equipment as at 31 December 2015 amounted to Euro 1,608,013 while the accumulated depreciation plus grants amounted to Euro 671,890. This means that the net book value of the property, plant and equipment owned by the Council as at the date of the statement of financial position amounted to Euro 936,123.
- 2.2 It is recommended that the Council updates its old fixed assets register or builds up a new one, so that the totals of each asset category match those in the nominal ledger in all respects, that is, cost, accumulated depreciation, grants and net book value. The more time is allowed to pass the more complex the exercise will become. The Council has informed us that they plan to work on the fixed assets register during 2016.
- 2.3 When testing the opening balances of the property, plant and equipment, we noticed that there was a variance of Euro 30,110. After we investigated this variance, we noticed that the same variance resulted in the deferred income accounts. For some reason there were adjustments between the property, plant and equipment accounts and the deferred income accounts. An audit adjustment was passed to correct these errors.
- 2.4 It is of utmost importance that once the audit is finalised and the Local Council is provided with the final extended trial balance and the list of the approved audit adjustments, a reconciliation of the opening balances is immediately carried out.
- 2.5 It was also noted that the Council's calculations of the depreciation charge for the year were incorrect. The depreciation was calculated again by us and an audit adjustment was passed to reduce the depreciation charge for the year of special programmes by Euro 15,964 while increasing the depreciation charge for the year of constructions by Euro 14,426, of office furniture by Euro 104 and of urban improvements by Euro 290.
- 2.6 We suggest that once the fixed assets register is updated, then the depreciation charge should be calculated and posted directly through the register. Until such exercise is carried out, it is important that care is taken when calculating the depreciation manually to ensure that the opening net book values are taken correctly, that the additions are taken into account from the correct date of acquisition or the date of completeness of the project and that the calculations are made in line with the accounting policies adopted by the Local Council.
- 2.7 During our testing on the adequacy of the insurance coverage of the property, plant and equipment, we found that the furniture and fittings are under insured by Euro 11,489 since the insurance covers the amount of Euro 9,400 while their net book value amounts to Euro 20,889. Even the buildings and properties in the open are under insured. The total insurance coverage of buildings and property in the open is Euro 83,300, while the net book value of assets categories construction, urban improvements and special programmes amounted to Euro 657,353 as at 31st December 2015. Equipment and plant and machinery are adequately covered.
- 2.8 If assets are under insured, in the case of theft, fire or any other accident, the Local Council will not be in a position to recover all the losses incurred. We therefore highly suggest that the Local Council takes the necessary steps to ensure that an insurance policy is taken that adequately covers all the items of property, plant and equipment.
- 2.9 During our testing of the fixed assets additions, an amount of Euro 600 was noted to have been capitalised. This related to a study which was carried out to determine the extent of which the valley of Mgarr ix-Xini can be upgraded. Following the study, the Council decided that it could not embark on such a project. Therefore this amount should not have been capitalised as the Council will not again any future benefits from such expenditure. No adjustment was passed to correct this error as the amount was deemed to be immaterial.
- 2.10 In the previous years, it was noted that depreciation started being charged on the costs relating to the new Council premises before it was available for use and also that the

borrowing costs incurred in relation to the construction, which amounted to Euro 10,018, were not capitalised in accordance with International Accounting Standard 23 – Borrowing Costs. The total costs incurred on the new Council premises at the time it was available for use, amounted to Euro 182,034 excluding the bank loan interest not capitalised. These costs should have been depreciated since May 2012. During this year's audit, we calculated again the impact of such wrong accounting which was never corrected. The net book value of such project should amount to Euro 132,896 while in the books of accounts of the Council it is shown at Euro 106,055, a difference of Euro 26,841. Also, the difference on the depreciation charge for the year under review amounts to approximately Euro 2,835. No adjustment was passed in this respect and an audit qualification had to be included in our audit report.

3.0 RECEIVABLES

- 3.1 When an activity is held or eligible expenditure is incurred on a particular project, and there are government grants attributable to that activity or project which are still wholly or partly to be received, the accrued income with respect to that grant or part thereof should be accounted for. During the audit, we had to adjust the grant still due to the Local Council for Pjazzetta Xelina by Euro 24,901, in line with the eligible expenditure incurred during the year on this project which was then completed in March 2016. We also had to account for the grant still due to the Local Council for the Organ Festival that took place during 2015, amounting to Euro 4,000, as it was omitted from the accounts.
- 3.2 The concept of recording accrued income in the period as it accrues should be respected. The Council should know what income is receivable and still not received by the time of drawing up the financial statements and as such should be able to accrue for that income. We strongly recommend that the accruals concept is embraced by the Council.

4.0 PAYABLES

- 4.1 A number of adjustments were deemed necessary to be passed to reflect the correct amount of amortisation of the deferred income for the year. The adjustments passed were the following:
- 4.1.1 Amortisation with respect to the PPP Scheme was understated by Euro 105;
 - 4.1.2 Amortisation with respect to the Tal-Bidwi Park and Rubble Wall at Ras in-Newwiela was understated by Euro 2,400;
 - 4.1.3 Amortisation with respect to Accessibility Scheme was overstated by Euro 100;
 - 4.1.4 Amortisation with respect to the Photovoltaic panels installed was overstated by Euro 78;
 - 4.1.5 Amortisation with respect to the Mgarr ix-Xini project was overstated by Euro 1,139; and
 - 4.1.6 Amortisation amounting to Euro 1,095 was mistakenly included in the wages payable account.
- 4.2 When a project of a capital nature is completed and depreciation is commenced on the depreciable amount, the amortization of the related deferred income should also be commenced as from the same date. This would ensure that the income is matched with the expense it is intended to cover. We noticed that in some cases this was not the way that the amortisation of the deferred income was being calculated.

- 4.3 We recommend that in the future, the matching concept and the application of the International Accounting Standard 20, are correctly applied. It is important that funds received are allocated as deferred income until the respective works are completed. Once the works are completed, the treatment of the grant is to be made on the income approach basis in accordance with International Accounting Standard 20.
- 4.4 A reclassification had to be made between the different deferred income accounts as funds received with respect to Piazza Xelina of Euro 24,429 were posted under another deferred income account.
- 4.5 Care should be taken when posting transactions relating to funds received in relation to capital projects to ensure that they are accounted for in the appropriate nominal account. Accounting the deferred income of one project in the account relating to another project, might lead to errors in when amortisation is started and on which amount it is to be calculated.
- 4.6 When testing the accounts payable, a debit balance was noted in the aged list of the payables. This resulted due to a double payment made to one of the suppliers. This was supposed to be paid from the funds of the respective Measure. However, the Council also paid this amount from its own funds. The Executive Secretary stated that he will either get a refund of the amount or get a credit note to be used against other future purchases from this supplier. A reclassification of the negative amount of Euro 1,799 was passed to transfer the balance to under the receivables.
- 4.7 It is important that the Council keeps proper track of which invoices have been paid, if need be, make use of a rubber stamp. Reference should also be made to the supplier's account in the books of the Local Council before affecting any payments to see what is still due at that point in time.
- 4.8 Works of approximately Euro 17,000 carried out during 2015 have not yet been certified and no invoices for such works were yet issued by the supplier. This resulted in an accrual being accounted for based on the estimate of the works carried out, which estimate may be different from the actual invoice that will eventually be issued.
- 4.9 It is imperative to point out that an accrual for works not yet invoiced and not even certified, should at least be based on an estimate made by the architect in charge of the project so that if there were variances in the works carried out these would also be taken into consideration.
- 4.10 Two adjustments were passed by the Council, amounting to Euro 6,088 and Euro 1,833 respectively, to reverse accruals for which no payment has yet been made and the invoices not yet accounted for either. These entries were reversed and the payable amounts were accounted for under the accounts payable as the invoice were in fact issued during the year.
- 4.11 The concept of recording liabilities and costs in the year as they accrue should be respected. The Council should know what orders for works and services were made and still not invoiced by the time of drawing up the financial statements and as such should be able to either accrue for the cost or request a copy of the invoice or statement from the respective suppliers. We strongly recommend that the accruals concept is embraced by the Council. Furthermore, the Local Council should ensure that all invoices received are immediately accounted for irrespective of from which funds they are going to be paid.

5.0 INCOME

- 5.1 Instances were encountered whereby the amortisation of the deferred income was incorrectly calculated. As a result of this, audit adjustments were passed amounting to Euro 3,613 that reduced the income for the year.
- 5.2 We recommend that the Council starts applying International Accounting Standard 20: Government Grants, correctly. It is important that funds received for projects of a capital nature start being amortised only from the date when the capital asset is completed and ready

for use while funds received for projects of a revenue nature are written off to the statement of comprehensive income to be matched with the expenses they are intended to cover.

- 5.3 During our review of the income accounts, we noticed an amount of Euro 185 which was posted in the amortisation for the year of the deferred income account when it was not related to such income. Therefore a reclassification adjustment was passed to transfer it to the appropriate nominal account.
- 5.4 It is important that income is allocated to the appropriate category to ensure correct presentation of income in the financial statements and ensuring comparability from one year to the other.

6.0 EXPENDITURE AND TENDERS

- 6.1 We noticed that the Council does not draw up purchase requests in line with the Local Councils Financial Procedures. There appears to be no specific reason behind this practice.
- 6.2 It is understood that at times the urgency of matters might require the reduction of bureaucracy as much as possible, however we are still of the opinion that the necessary paperwork should have been done in line with the financial procedures.
- 6.3 The Council has exceeded the budgeted expenditure under the following categories:

Utilities (category 2100) – by Euro 1,337
Repairs and maintenance (category 2300) – by Euro 1,587
Rent (category 2400) – by Euro 250
Office costs (category 2600) – by Euro 478
Transport (category 2700) – by Euro 209
Contractual services (category 3000) – by Euro 11,164
Social events (category 3300) – by Euro 2,450
Other incidental costs (category 3400) – by Euro 6,824

- 6.4 The Financial Procedures applicable for Local Councils require Councils to draw up twelve (12) months budgets, three (3) years business plans, quarterly reports and eventually yearly administrative reports at the end of the year. The Council is also allowed to revise budgets in line with actual requirements and there are enough reporting tools to note which areas in the budget need revising.
- 6.5 We recommend that the Council makes use of the reporting tools in hand to take corrective measures in the budget every quarter such that by the end of the accounting year such discrepancies would not materialise. We also recommend that the Council starts using purchase requests in line with the Local Councils Financial Procedures.
- 6.6 The street lighting contract used by the Council was entered into by the Joint Committee. It originally expired on 3 April 2008 but was then extended for another year until 3 April 2009. However, no proof of further formal extensions was ever traced. During the year under review, the Local Council was still using the services of the same supplier with the same terms and conditions set out in the original contract.
- 6.7 Memo 34/2013 instructed Local Councils using expired contracts for street lighting to issue a call for new offers either individually or jointly with other Local Councils, given that discussions were still underway to eventually transfer the maintenance of street lighting to the Regional Committees. These instructions were not followed as mentioned above.

7.0 PAYROLL

- 7.1 It was noted that the councillors' allowances were being shown as part-time emoluments in the FS5s while they were being shown as full time emoluments in the FS3s and the FS7.

- 7.2 It is important that the Local Council is consistent in the way the FSS forms are filled in and should ensure that such forms are always filled in correctly. The councillors' allowances should always be declared under the full-time emoluments.
- 7.3 When checking the tax deductions of the clerk we noted that it is being calculated incorrectly. The tax that should have been deducted for the year, based on the single tax rates, amount to Euro 1,699. The actual tax deducted for the year amounted to Euro 3,208.
- 7.4 The Executive Secretary has already been informed of this error during the audit and action to correct this error has already been taken. It is important that when calculating the tax deductions on the wages and salaries paid, care is taken to ensure that the proper tax rates are used and that the calculations are worked out correctly.

8.0 LIQUIDITY

- 8.1 The Statement of Financial Position on page 4 of the financial statements indicates that the current liabilities exceed the current assets by Euro 118,269. This implies that the Council does not have enough current assets to support its current liabilities.
- 8.2 The current ratio is Euro 0.45 of current assets for every Euro 1.00 of current liabilities indicating that the Council may be in a situation of 'overtrading'. The acid test ratio is in fact only Euro 0.18 of cash and cash equivalents for every Euro 1.00 of current liabilities.
- 8.3 The Local Council is also projecting further capital expenditure for the financial year 2016 as disclosed in the capital commitments note 18 to the financial statements. The said note indicates that there are Euro 142,800 worth of capital commitments out of which Euro 21,500 are already contracted for. However, it is also important to note that the Local Council will obtain specific funds for most of these capital projects.
- 8.4 We recommend that the Council curtails its current expenditure and does not enter into further capital expenditure until the cash deficit situation is remedied.

9.0 FINANCIAL SITUATION INDICATOR

- 9.1 The Financial Situation Indicator held by the Council at the Statement of Financial Position date stood at negative 38.14% which falls well below the 10% threshold required by the Financial Provisions to the Local Councils Act. A Financial Situation Indicator which falls below the 10% margin implies that the Council is possibly not effectively managing its payables and cash flows, venturing into activities which are not budgeted for.
- 9.2 Kindly note that the Financial Situation Indicator has been calculated as the non-restricted current assets less current liabilities (excluding the deferred income) as a percentage of the Central Government allocation received in terms of Section 55 of the Local Councils Act (Chap. 363).
- 9.3 The Council should manage the working capital more attentively, in order to avoid such a negative Financial Situation Indicator. Moreover it is recommended that the Council obtains the necessary clearance from the Department for Local Government if it anticipates a Financial Situation Indicator level which will fall below the 10% threshold in future years.

10.0 OTHER MATTERS

- 10.1 In the unaudited financial statements provided to us for the audit, we noticed that the Council passed a prior year adjustment amounting to Euro 6,693 and restated the previous year's figures. The adjustment passed was between the government income and the deferred

income and the note stated that the net adjustment related to a change in the accounting policy with respect to the accounting for deferred income grants.

- 10.2 In reality there was no change in accounting policy but there was simply a correction of some minor differences found including the adjustment of the amortisation rate applied to one of the deferred income as the percentage applied last year was not correct. In view of this fact and the fact that the amount was not deemed material to justify a prior year adjustment, the prior year adjustment was reversed except for Euro 6 whose entry could not be traced and was not further investigated. This untraced variance was just written off to the statement of comprehensive income as amortisation for the year

Responsibility Statement

While our report includes suggestions for improving accounting procedures, internal controls and other aspects of the Local Council arising out of our audit, we emphasise that our consideration of the Local Council's system of internal financial control was conducted solely for the purpose of our audit having regard to our responsibilities under International Standards on Auditing. We make these suggestions in the context of our audit but they do not in any way modify our audit opinion which relates to the financial statements as a whole. Equally, we would need to perform a more extensive study if you wanted us to make comprehensive review for weaknesses in existing systems and present detailed recommendations to improve them.