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21st May 2020

The Mayor
Local Council Sannat
Sannat Road,
Sannat,
Gozo

Dear Mayor

RE: MANAGEMENT REPORT FOR THE YEAR ENDED 31 DECEMBER 2019

We have completed our audit of the financial statements of the Local Council Sannat for the year ended 31 December 2019. 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 9 of this report.

During the course of our audit for the year ended 31 December 2019, 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.

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

Local Council Sannat

Management Report for the year ended 31 December 2019

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1.0 Follow-up to Last Year's Report

1.1 Property, Plant and Equipment

In the prior year, we noted that upon the application of Directive 01/2017, items of property, plant and equipment whose useful life expired, were not written off, depreciation for the year was applied on the carrying values as at 1 January 2018 at the applicable depreciation rates as if the assets' useful life started in 2018 rather than using the remaining useful lives, and the allocation of grants to the respective assets was not properly carried out. No action was taken on these issues during the current year.

The Local Council capitalised grants that related to projects that were not yet carried out. These projects were done in 2019.

Other weaknesses encountered last year on property, plant and equipment included expenditure not covered by a VAT fiscal receipt and inadequate insurance coverage. No such issues were encountered this year.

1.2 Receivables

Last year, it was noted that in the debtors' list there was an amount shown as receivable that was already received during the year. The receipt was incorrectly accounted for as income rather than posted in the debtor's ledger to settle the balance. This weakness was not found during the 2019 audit.

Furthermore, we were not provided with any evidence that funds amounting to €12,050 within the accrued income, receivable from the Malta Environment and Planning Authority for the refurbishment of a playing field which project was completed back in 2013, are still receivable. In view of the uncertainty on the recoverability of such funds, we modified our audit opinion on this matter. This was once again encountered during this year's audit as the funds were not yet received.

1.3 Cash and Bank

During our cash count reconciliation, it has been noted that a cheque issued in 2019 to top up the petty cash, was entered in the petty cash account in 2018. We did not encounter such a case during the current year.

1.4 Payables

When testing the payables, last year we noted that two invoices dated in 2017 were found not accounted for in the prior period and an audit adjustment was passed in this respect. In 2018, the two invoices were once again accounted for through the payables' ledger separately. Hence, an audit adjustment was passed to reverse this double posting. No such instances were found during the current year's audit.

In addition, it has been noted that the accruals and the property, plant and equipment were understated since works not yet certified or works still in progress as estimated by the architect, were not accrued for.

1.5 Income

During 2018, the Local Council collected money on behalf of the Malta Community Chest Fund which was then passed on to the charity organisation. In the accounts, the money collected was being shown as income of the Local Council while the cheque issued from the Local Council to the Malta Community Chest Fund was being shown as an expense of the Council. Given that this money is neither income of the Council nor an expense, it was agreed to net off these two entries through an audit adjustment. The same situation was encountered during the current period.

Tax at source was being charged on the interest earned on one of the bank accounts held by the Local Council. Since the Council is not subject to tax, it was suggested that the bank should be informed not to charge tax. No action was taken during the year under review.

1.6 Expenditure and tenders

During the year ended 31 December 2018, the Council had exceeded the budgeted expenditure in several expenditure categories. This weakness was once again encountered during this year's audit.

During our testing, we also came across an expenditure which was double accounted for. No such issues were encountered this year.

1.7 Liquidity

As at 31 December 2018, the current liabilities exceeded the current assets by Euro 33,940 indicating possible liquidity problems. As at the end of the financial year under review, the Local Council experienced the same situation.

1.8 Financial situation indicator

As at 31 December 2018, the financial situation indicator of the Local Council stood at negative 14.57% which fell below the 10% threshold required by the Financial Provisions to the Local Councils Act. As at 31 December 2019, the financial situation indicator was still negative.

2.0 PROPERTY, PLANT AND EQUIPMENT

2.1 Following Directive 01/2017 issued by the Department for Local Government to Local Councils on the change in the accounting policies on depreciation and on government grants, we noticed from the limited procedures that we could carry out that:

2.1.1 Items of property, plant and equipment whose useful life expired, were not written off and these were estimated to have had a carrying value as of the date of the application of the new accounting policy of approximately €22,000.

2.1.2 Depreciation has been applied on the carrying values as at 1 January 2018 at the applicable depreciation rates as if the assets' useful life started in 2018, rather than using the remaining useful lives.

2.1.3 Grants received for specific projects, were allocated to several items of property, plant and equipment rather than to those specific projects, clearly indicating that the allocation of grants to the respective assets was not properly carried out.

2.1.4 As at 31 December 2017, the Local Council had received grants amounting to €46,498 relating to resurfacing works that were not yet carried out as of that date. Yet, we noticed that when the comparative figures were restated following the change in the accounting policy on government grants, these grants were still allocated against property, plant and equipment rather then left under deferred income. These projects were now completed during 2019 but these grants were not allocated against them as were already allocated against other assets.

2.2 We highly suggest that the exercise of applying the changes in the accounting policies is redone diligently and the necessary corrections made to the accounts through a prior year adjustment. Once the exercise is completed, the fixed assets register would need to be updated as well. When doing such an exercise, it is important to keep all the necessary workings to be able to reconcile the costs and accumulated depreciation as per updated fixed assets register to the figures shown in the note to the financial statements on property, plant and equipment.

2.3 The fixed assets register does not contain any details of the assets that have been fully depreciated and hence, one cannot obtain the breakdown of the costs, accumulated depreciation and grants of all the property, plant and equipment shown in the notes to the financial statements.

2.4 Whilst we understand that the carrying amount of these assets is nil, if there are any disposals one would not be able to trace the costs, accumulated depreciation and potential grants received with respect to those assets, to remove them from the accounts.

2.5 When analysing the items classified under the category 'assets under construction', we noticed that these related to a project that was originally going to be carried out by the Local Council. Following the issue of a tender it resulted that the costs for this project were far higher than what was being budgeted for. The Ministry for Gozo agreed that it will carry out the project itself and the Local Council could use the allocated funds for another project. In view of this, it was agreed that the items previously capitalised should be written of to profit or loss since they will no longer result into an asset of the Local Council.

2.6 The Local Council should continuously monitor the items under the category 'assets under construction' to follow the progress of the respective projects and if they are completed, the assets are to be transferred under the correct assets' category whilst if a project is abandoned as happened in this case, the costs are to be immediately written off.

2.7 When testing the depreciation charge for the year, we noted that depreciation on new additions to playground furniture and equipment was calculated at 10% when the accounting policy applicable to the Local Council states that it should be depreciated at 100%. An adjustment of €2,281 to depreciate the full amount was passed.

2.8 The Local Council should ensure that the appropriate depreciation rate is applied to every item of property, plant and equipment in line with the accounting policies applicable to the Local Council.

2.9 From our testing on the government grants capitalised under property, plant and equipment during the year, we noted that with respect to Measure 4.3, only 50% of the funds were capitalised. An audit adjustment of €28,270 was passed to reflect the remaining funds relating to this completed project. Another adjustment of €2,826 had to be consequently passed to adjust the depreciation charged for the year on this project.

2.10 It is important that before capitalising any grants relating to completed projects, the respective funding agreements are analysed to check the correct amount of funds that relate to the specific project, whether any funds are still receivable and the percentage of the costs to be covered including the capping of the funds. Such analysis including the details of the costs of the project should be made available to the auditors during the audit.

2.11 Despite the carrying value of the furniture and fittings as at 31 December 2019 as shown in the financial statements is only Euro 6,896 compared to the insurance coverage of Euro 9,400 we still believe that if the government grants had to be properly allocated to the correct items of property, plant and equipment, this category of assets would still be under insured as of today.

2.12 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.

3.0 <u>RECEIVABLES</u>

3.1 From our testing, it was noted that within the accrued income, there is an amount of €12,050 receivable from the Malta Environment and Planning Authority (MEPA) for the refurbishment of a playing field which project was completed way back in 2013. These funds have been due for more than 5 years now and we were not provided with any adequate evidence that such funds are still receivable. In view of the uncertainty on the recoverability of such funds, we modified our audit opinion on this matter.

3.2 We highly suggest that talks are held with MEPA with regards to these funds and get the commitment from their end in writing whilst the Local Council continues to chase such funds if they are still receivable.

4.0 <u>INCOME</u>

4.1 During the year, the Local Council collected €383 on behalf of the Malta Community Chest Fund and it had then passed over the money collected to the charity organisation. In the accounts, the money collected was being shown as income of the Local Council while the cheque issued from the Local Council to the Malta Community Chest Fund was being shown as an expense of the Council. Given that this money is neither income of the Council nor an expense, it was agreed to net off these two entries through an audit adjustment.

4.2 When testing the bank interest received by the Local Council, we noticed that for two of the bank accounts held with Bank of Valletta p.l.c., final withholding tax at 15% was being deducted. Since the Council is not subject to income tax, the bank should be advised to not withhold any tax on the interest.

5.0 PERSONAL EMOLUMENTS

5.1 When checking the honoraria of the Mayor, we noticed that the increment in the honoraria that came into effect as from 26th April 2019, was applied as from 1st May 2019. This means that the honoraria for the month of April was understated by €37. On the other hand, we then noticed that the honoraria for the month of December was €936 instead of €853, meaning an overstatement of €83.

5.2 The Local Council should be careful when calculating the honoraria paid to the Mayor and should follow the instructions given by the Department through the Circulars issued during the year, to ensure that the correct rates are applied and paid.

6.0 EXPENDITURE AND TENDERS

6.1 The Council has exceeded the budgeted expenditure under the following headings:

6.1.1 Public materials & supplies (category 2200) – by €1,919
6.1.2 National & international memberships (category 2500) – by €391
6.1.3 Office services (category 2600) – by €776
6.1.4 Contractual services (category 3010) – by €10,649
6.1.5 Professional & management services (category 3100) – €18,447
6.1.6 Hospitality & community (category 3300) – €7,349
6.1.7 Incidental expenses (category 3400) – €30

6.2 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 help the Council revise the budgets in line with actual expenditure.

6.3 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 period such discrepancies would not materialise.

6.4 Following Directive 03/2017 issued by the Department for Local Government to Local Councils on the change in the public procurement regulations, we noticed an instance from the samples tested, where the Council did not abide with the new regulations. The Local Council is acquiring services and goods relating to street lighting from the same supplier through direct orders. The amounts invoiced for 2019 totalled to €6,728.

6.5 We understand that the bureaucratic requirements of the public procurement regulations may be cumbersome. However, we highly suggest that the Council adopts these regulations to full effect.

7.0 LIQUIDITY

7.1 The Statement of Financial Position on page 5 of the financial statements indicates that the current liabilities exceed the current assets by Euro 105,221. This implies that the Council does not have enough current assets to support its current liabilities.

7.2 The current ratio is Euro 0.83 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 0.75 of cash and cash equivalents for every Euro 1.00 of current liabilities.

7.3 We recommend that the Council curtails its current expenditure and does not enter into capital projects until the cash deficit situation is remedied.

8.0 FINANCIAL SITUATION INDICATOR

8.1 The Financial Situation Indicator held by the Council at the Statement of Financial Position date stood at negative 27.37% 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.

8.2 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).

8.3 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.

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.