EXECUTIVE SUMMARY

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Over the past five years – from the period 2010-11 to 2014-15 – municipalities in South Africa have reported a **steady improvement in audit outcomes**, with 53% having improved, while 13% regressed and 34% remained unchanged. The audit outcomes of six of the eight metro councils, 21 (49%) district municipalities and 116 (52%) local municipalities have improved.

Positioned against government's medium-term strategic framework (MTSF) targets for improving audit outcomes in pursuit of sound financial and administrative management, this compares as follows:

- 10% of municipalities with adverse or disclaimed audit opinions against the target to have no municipalities with these type of opinions by 2019
- 28% of municipalities with qualified audit opinions against the target to have a maximum of 25% of municipalities with such opinions by 2019
- 59% of municipalities with unqualified audit opinions against the target to see at least 75% of municipalities to achieve this desirable state by 2019.

The expenditure budget for the municipal sphere in 2014-15 totalled R347 billion. Municipalities with clean audit opinions represent R134 billion (39%) of this amount, while those with unqualified opinions with findings represent R143 billion (41%). Municipalities with qualified audit opinions made up R49 billion (14%) of the total budget, with those with adverse and disclaimed opinions representing R20 billion (6%). The outstanding audits constitute R1 billion of the total budget.

Increased accountability and transparency within local government are evident in the significant improvement made in **submission of financial statements for audit by the legislated date** and the **preparation of annual performance reports**. The financial statement submission rate improved from 78% to 94%, while the number of municipalities that failed to prepare annual performance reports decreased from 14% to 4%.

The provinces with the highest proportion of municipalities with clean audit opinions in 2014-15 were the Western Cape (73%), Gauteng (33%) and KwaZulu-Natal (30%). Leadership in these provinces has proved the value of investing in strengthening internal control, valuing stability in the administration of municipalities and taking decisive action on both internal control failings and audit findings. This does not mean that these provinces find themselves without challenges, as the situation in the Central Karoo District Municipality (Western Cape), the West Rand District Municipality (Gauteng) and the Umkhanyakude District Municipality (KwaZulu-Natal) testifies.

The audit outcomes of municipalities in the Eastern Cape, Free State and Mpumalanga have shown momentum in the right direction. I am particularly encouraged by the solid outcomes reported in areas such as the Joe Gqabi District Municipality in the Eastern Cape, the Thabo Mofutsanyana District Municipality in the Free State and the Ehlanzeni District Municipality in Mpumalanga. I encourage leadership in these provinces to re-emphasise the benefits of good governance at all municipalities as a key mechanism to create a fertile environment for appropriate service delivery and to back this up with decisive action in setting the appropriate tone at the top, investing in the right skills and competencies for key positions and further maintaining good record-keeping practices at all municipalities. Each of these provinces also faces immense challenges in specific areas, such as the OR Tambo District Municipality in the Eastern Cape and Matjhabeng in the Free State where urgent and focused leadership attention is required.

Audit outcomes in the remaining three provinces – Limpopo, North West and the Northern Cape – have been disappointing at best. Focused political will and a considerable investment in ensuring that the basics are done right at municipalities in these provinces are required to create a baseline from which good governance can be restored and strengthened.

The audit area that showed the **greatest improvement was the audit opinions on financial statements**. The number of unqualified audit opinions increased from 47% to 59%, while municipalities receiving disclaimed or adverse opinions decreased from 33% to 11%. The items that municipalities struggled with most to correctly measure and disclose in the financial statements over the past five years were *property, infrastructure and equipment, revenue* and *irregular expenditure*, but there has been improvement in all three areas – most notably property, infrastructure and equipment.

Municipalities continue to **rely on consultants** to prepare financial statements and underlying records and also rely **on auditors** to identify material misstatements to be corrected. Consultancy costs for financial reporting services continued to increase over the past five years to R892 million in 2014-15. Similarly, the poor quality of the financial statements submitted for audit resulted in increased audit time and cost. In 2014-15 only 26% (and not 59%) of municipalities would have received an unqualified audit opinion had we not identified the misstatements and allowed them to make corrections.
We found that at 105 municipalities (42%), the financial statements submitted for auditing included material misstatements in the areas in which consultants did work, meaning that the misstatements were identified and corrected by the audit process and not by the consultant. This remains a concern regarding the effective use of these consultants.

The **management of consultants** (not limited to financial reporting services) continues to be inadequate. Weaknesses in the planning and appointment processes, performance management and monitoring and transferring of skills were identified at 68% of the municipalities that used consultancy services.

The **quality of annual performance reports has improved**, with the number of municipalities with no material findings in this regard having increased from 20% to 38% since 2010-11. The *usefulness* of the information in the report has significantly improved (from 71% with findings to 47%) but more than half are still struggling to report *reliable* information on service delivery.

The audit area with the **lowest improvement rate is compliance with key legislation**. The number of municipalities with material findings on compliance has decreased from 95% to 78% since 2010-11. The only areas we audit that have shown some improvement in this period were procurement and contract management (also referred to as supply chain management) (from 79% to 68%) and the quality of submitted financial statements (from 82% to 74%) – there has been little change and even regression in all other areas.

Although the number of municipalities with material findings on supply chain management (SCM) had declined, the number of municipalities with **SCM findings** (material and not material) has remained **at the same level** since 2011-12. The limitations we have experienced in auditing SCM as a result of missing documentation have eased over the period but we still experienced such limitations at 22% of municipalities in 2014-15. We reported inadequate contract management at more municipalities than in 2011-12 and have seen little improvement in the past four years in addressing uncompetitive or unfair procurement processes and the high prevalence of awards being made to suppliers in which employees, councillors and state officials have an interest. Furthermore, little progress has been made in complying with legislation relating to awards made to close family members of employees and councillors.

Irregular expenditure has more than doubled since 2010-11 to R14,75 billion and is incurred by an increasing number of municipalities. The reason for the increase in irregular expenditure is the continued non-compliance with SCM legislation, but also an improvement in the ability of municipalities to detect and disclose current and prior year irregular expenditure in their financial statements. In 2010-11, 73% of the irregular expenditure was identified during the audit, while in 2014-15 municipalities identified 69% of the irregular expenditure – some using consultants to determine the full extent of irregular expenditure. Municipalities in North West, Mpumalanga, Eastern Cape and Limpopo were the main contributors to the significant increase in irregular expenditure over the past five years.

Fruitless and wasteful expenditure in 2014-15 was more than R1 billion higher than in 2010-11 at R1,34 billion and was again incurred by an increasing number of municipalities. Municipalities in the provinces of Mpumalanga, Eastern Cape, North West, Free State and Northern Cape were the main contributors to this increase. **Unauthorised expenditure** has also increased threefold since 2010-11 to R15,32 billion. The main reason for the unauthorised expenditure remains overspending of the budget; however, more than 60% of the overspending related to non-cash items, i.e. estimates of depreciation or impairments that were not correctly budgeted for.

The poor quality of financial statements submitted to us for audit and the continuing reliance on consultants for financial reporting services call into question whether in-year reporting and management of finances by municipalities are solid. Signs of **poor financial management** are apparent in the budget preparation and monitoring processes (resulting in unauthorised expenditure) and the financial viability of municipalities, which continue to weaken year on year.

In 2014-15 we rated the **financial health** of 92% of the municipalities as either concerning or requiring intervention (82% in 2012-13 when our overall assessments were introduced). The most concerning indicators over the past three years were municipalities spending more than the resources they had available (thus incurring a net deficit); current liabilities exceeding current assets at year-end (net current liability position); debtors (ratepayers and consumers of water and electricity) not paying or taking very long to pay their debt; and creditors not being paid on time. In total, 26% (just over a quarter) of municipalities were in a particularly **poor financial position** by the end of 2014-15, with material uncertainty with regard to their ability to continue operating in the foreseeable future – 10 more municipalities than in 2012-13.

As local government does not generate enough revenue to fund all its operations and capital projects, national government provides **conditional grants** to municipalities for specific purposes. We have broadened the scope of our audit in the past two years to consider the management and impact of the municipal infrastructure grant (MIG) and the municipal systems improvement grant (MSIG), both allocated by the Department of Cooperative Governance and Traditional Affairs (CoGTA), as well as the financial management grant (FMG) allocated by the National Treasury. We raised similar findings as in 2013-14 in that although most of the funds were used, the targets identified for the programmes and projects funded by the grants were not achieved by all municipalities. In the case of the FMG and MSIG, the impact on improved financial and performance management is not always evident in the audit outcomes of the municipalities. In 2014-15 we increased the number of MIG-funded projects audited and focused on water and sanitation projects. We found that the targets of 52% of the projects we audited were either not achieved or the municipalities had not assessed their performance against targets.

The root causes of the aforementioned weaknesses in financial and performance management and the poor audit outcomes are as follows:

- Management (accounting officers and senior management), the political leadership (mayors and councils), as well as oversight – municipal public accounts committees (MPACs) and portfolio committees – do not respond with the required urgency to our consistent messages about addressing risks and **improving internal controls**. There has been some improvement in the control environment of municipalities over the past five years, but progress has been slow and in 2014-15 we rated the majority of municipalities' status in all areas of control as either 'concerning' or 'intervention required'. Of particular concern is the status of information technology (IT) controls, although some improvement has been evident over the past five years and the implementation of the IT governance framework is expected to have a positive impact on municipal IT control environments.

- **Vacancies and instability in the key positions** of municipal manager, chief financial officer and head of SCM unit affect the financial and performance management of municipalities and can directly affect audit outcomes. The impact on audit outcomes was apparent in the regression in audit outcomes (across all three audit areas) in 2011-12 as a result of the instability created after the 2010-11 elections. In 2014-15 we again identified a direct correlation between stability in the municipal manager and chief financial officer positions and audit outcomes. The **competency levels** of these key officials also contribute to their performance. We started tracking vacancies, stability and achievement of the minimum competency requirements as from 2012-13, noting an improvement in the number of key officials with the required competency since 2012-13. Improvement was also seen in addressing vacancies and creating stability, but of concern was that vacancies in chief financial officer positions stood at 20% by 2014-15 year-end, with those of municipal managers at 17%.
- The low level of action in response to the high levels of non-compliance, poor audit outcomes, SCM transgressions and unauthorised, irregular as well as fruitless and wasteful expenditure demonstrates a **lack of consequences** in local government for poor performance and transgressions. Councils at 45% (47% in 2013-14) of municipalities that reported unauthorised, irregular and fruitless and wasteful expenditure in the previous year had not investigated these transgressions as required by the Municipal Finance Management Act (MFMA). We also continue to report to management indicators of possible fraud or improper conduct in the SCM processes for investigation, to little avail as the cases continue to increase and in most instances are not investigated.

Our report includes **recommendations** to local, national and provincial administration and oversight to sustain the improvements witnessed over the past five years and addresses the risks emerging in the environment. These include the following best practices displayed by those provinces and municipalities that have shown improvement in the past five years:

- Political, municipal and provincial **leadership** delivered on commitments to fill key positions with competent people, stabilised the administration (i.e. low turnover in key positions) and provided officials the opportunity to obtain the minimum competency requirements. They showed courage in dealing with transgressions and poor performance and insisted on credible in-year reporting by officials, which improved the year-end processes and enabled improved decision-making. Leadership supported and participated in initiatives to improve audit outcomes, such as operation clean audit, and used forums and working relationships between municipalities and with provincial government to strengthen the administration of municipalities.
- The municipal managers and senior managers **improved financial and performance management** by implementing audit action plans to address the audit findings as well as the root causes of the audit findings. They improved the record keeping of municipalities, ensured that the basic controls around transactions and reconciliations are in place and enabled monitoring and oversight through regular and credible reporting on important matters such as SCM and contract management.
- The **governance** of these municipalities was greatly enhanced by well-functioning audit committees and the support of internal audit units. Councils and municipal management implemented the recommendations of the audit committees and used the internal audit units to identify risks and the controls that can be implemented to mitigate the risks.

The initial outcomes that I have observed from the back-to-basics programme recently launched by CoGTA bode well for the municipal sphere in South Africa. Where these interventions have been taken up by stable leadership in an environment where strong internal controls are valued and where the needs of the community remain a paramount consideration, audit outcomes have improved and stabilised to a point where service delivery can take place in a well-governed environment.

I also recognise the considerable effort made by the South African Local Government Association (Salga) to join hands with National Treasury and CoGTA to support municipalities. Salga's municipal audit support programme (MASP), which was launched mid-2014 and focuses specifically on addressing challenges experienced by so-called 'red zone' municipalities, certainly contributed to the downward trend in adverse and disclaimed audit opinions.

My office remains committed to working tirelessly within our mandate to strengthen financial and performance management in local government in South Africa, emphasising the need to do the basics right. I also pledge my office's support in assisting mayors and councils to start from an appropriate foundation for their five-year terms following the 2016 municipal elections.

Introduction

This general report provides an overview of the audit outcomes and our messages since 2010-11, which was the last year of the previous local government administration. The purpose of this five-year overview is to share the trends we have observed in the financial and performance management of local government in order to highlight risks and make recommendations for improvement.

Our intention this year was to provide a simplified, single general report, followed by more in-depth and focused interactions with the newly elected mayors and councils in the latter part of the year to share our insights at a more detailed level.

In previous years we tabled a consolidated report and nine provincial general reports and included information that explains the work we do and how the results should be understood or interpreted. This report now includes a consolidated view (sections 2 to 8) and a five-year overview per province in section 9. We focus on municipalities throughout the report, but provide a summary of the key audit outcomes of municipal entities in section 6. For the sake of brevity, some of the explanatory information normally included in the general report is now included in section 11 or can be sourced from our previous year's report.

When studying the figures and reading the report, please note that the percentages are calculated based on the completed audits of 272 municipalities, unless indicated otherwise. Movement over a period is depicted as follows:

- Improved
- Unchanged/ slight improvement / slight regression
- Regressed