



1 June 2016

## Auditor-general reports an overall, encouraging five-year improvement in local government audit results

**PRETORIA** – The auditor-general (AG), Kimi Makwetu, today reported an encouraging improvement in the audit results of South Africa’s municipalities over the past five years.

Releasing his report on local government audit outcomes for the 2014-15 financial year, Makwetu revealed that municipalities have shown an encouraging improvement in their audit results over the past five years from 2010-11 to 2014-15. He said the number of municipalities that received financially unqualified audit opinions with no findings (commonly known as “clean audits”) had increased from 13 to 54. However, 18 additional municipal entities also achieved clean audit status, taking the total number of clean audits to 72 in the current period.

There were notable regressions during this period at 13%, while 34% of municipalities recorded the same outcomes as in 2010-11. Another welcome development in these audit outcomes is the significant reduction in adverse and disclaimed opinions, which have decreased from in excess of 30% in 2010-11 to about 11% of municipalities in the current period.

We recognise the considerable efforts made by the South African Local Government Association (Salga), the National Treasury, and the Department of Cooperative Governance and Traditional Affairs (CoGTA) in addressing the root causes of disclaimers.

These developments and improvements augur well for further tightening of financial management disciplines in local government. We commend the mayors and other oversight structures for their focused attention and decisive leadership that have ensured that basic administrative and financial disciplines are restored and observed.

In our report we single out the following disciplines and practices as major contributors to the improvements in audit outcomes:

- 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 meet the minimum competency requirements.
- Leadership showed courage in dealing with transgressions and poor performance and insisted on credible in-year reporting by officials, which in turn resulted in improved 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 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 also improved record keeping at the 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 supply chain and contract management.
- Governance at 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 such risks.

## **The audit outcomes at a glance**

In its annual audits, the Auditor-General of South Africa (AGSA) examines the following aspects:

- Fair presentation and absence of material misstatements in financial statements
- Reliable and credible performance information for purposes of reporting on predetermined performance objectives
- Compliance with all legislation governing financial matters.

The audited institution achieves a clean audit when their financial statements are unqualified, with no reported audit findings in respect of either reporting on predetermined objectives or compliance with legislation.

The audit outcomes of 272 municipalities and a summary of the key audit outcomes of 52 municipal entities are included in the latest general report.

### **Total local government expenditure budget in 2014-15**

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, while those with adverse and disclaimed opinions represented R20 billion (6%). The municipalities with outstanding audits constitute R1 billion of the total expenditure budget.

### **Provinces with the highest proportion of clean audit opinions**

The AG's report shows that 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%). The AG commended the leadership in these provinces for having "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. There are still other internal control weaknesses and a lack of administrative and financial disciplines, largely concentrated at municipalities in the Central Karoo, West Rand, and Umkhanyakude districts."

## **Provinces with municipalities that have shown the right momentum in their audit outcomes**

Makwetu said the audit outcomes of municipalities in the Eastern Cape, Free State and Mpumalanga are starting to emerge from many years of negative audit outcomes.

“I am particularly encouraged by the solid outcomes reported at municipalities within the Joe Gqabi district in the Eastern Cape, as well as the Thabo Mofutsanyana District Municipality in the Free State. 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 continuing good record-keeping practices in all municipalities.”

Each of these provinces, he said, also faces immense challenges in specific areas, such as the municipalities in the OR Tambo district in the Eastern Cape and Matjhabeng municipality in the Free State, where urgent and focused leadership attention is required. In similar vein the Mpumalanga province may face the risk of outcomes stagnating if leadership does not intervene in a decisive way across the province.

## **Provinces that still need to strengthen their governance systems**

The AG asserted that the audit outcomes of municipalities in Limpopo, North West and the Northern Cape have been disappointing at best. Of these, the Northern Cape has probably shown improvement in recent times, although it still needs to address a high percentage of disclaimed audits, as well as late submission of financial statements. He says focused political will and a huge 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.

## **Other significant audit observations**

The AG’s report shows that the area in which the greatest improvement was recorded 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.

### **Significant improvements in timeous submission of financial statements**

The report shows that there has been a significant improvement in the submission of financial statements by the legislated date, as well as the preparation of annual performance reports. This, the AG said, can largely be attributed to increased accountability and transparency in local government. 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%.

However, the AG was quick to point out that the poor quality of the financial statements submitted for audit resulted in increased audit time and cost. He said that 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, which meant 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”, he cautioned.

### **Continued reliance on consultants**

Makwetu said municipalities continue to rely on consultants to prepare financial statements and underlying records and rely on auditors to identify material misstatements to be corrected. To this end, consultancy costs for financial reporting services continued to increase over the past five years to R892 million in 2014-15.

“The management of consultants (not just 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 AG said.

### **Improved quality of annual performance reports**

The AG’s report indicates that 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 these reports has significantly improved (from 71% with findings to 47%) but more than half of the municipalities are still struggling to report reliable information on service delivery.

### **Compliance with relevant key legislation**

The AG said the audit area with the lowest improvement rate was compliance with key legislation that governs municipal operations. The number of municipalities with material findings on compliance has decreased from 95% to 78% since 2010-11. He said the only areas audited by his office that have shown some improvement in this period were supply chain management (from material findings at 79% of municipalities to 68%) and the quality of submitted financial statements (from findings at 82% of municipalities to 74%). In all other areas there has been little change and even regression.

### **Supply chain management**

Although the number of municipalities with material supply chain management (SCM) findings had declined, the number of municipalities with SCM findings (material and non-material) has remained at the same level since 2011-12. The limitations the AGSA has experienced in auditing SCM as a result of missing documentation have eased over the period but the auditors 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 the legislation on making awards to close family members of employees and councillors.”

## **Irregular expenditure**

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, Makwetu notes, is 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**

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**

Unauthorised expenditure also increased threefold from 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.

## **Financial health of municipalities**

In 2014-15 the AGSA rated the financial health of 92% of the municipalities as either concerning or requiring intervention. The figure stood at 82% in 2012-13 when the 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 2011-12,” said Makwetu.

### **Management and impact of municipal grants**

In the past two years, the AGSA has broadened the scope of its audits to consider the management and impact of the municipal infrastructure grant (MIG) and the municipal systems improvement grant (MSIG), both allocated by CoGTA, as well as the financial management grant (FMG) allocated by the National Treasury.

Conditional grants are provided to municipalities by national government for specific purposes because local government does not generate enough revenue to fund all its operations and capital projects.

Stated the AG: “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.

### **More key actions municipalities could take to further improve the audit results**

Makwetu urged local government leadership, especially municipalities that did not achieve the desired audit results, to address the root causes of the aforementioned weaknesses in financial and performance management and the poor audit outcomes 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 the AGSA's 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 have a direct effect on 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 instability 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 good 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 since then in the number of key officials with the required competency. 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 slow 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 the indicators of possible fraud or improper conduct in the SCM processes for

investigation, to little avail as these cases continue to increase and are not investigated in most instances.

“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. So, as we acknowledge the improved audit result trend, we also appeal to the leaders who will take office after the local government elections to strive to sustain, and further emulate, the improvements witnessed over the past five years. We’ll continue to work closely with local, provincial and national administrations to ensure that our key messages and recommendations on, among others, strengthening basic internal controls, improving consequence management and stability in key positions, are implemented. That is one of the ways in which we can collectively ensure public confidence in our local government administration,” concluded Makwetu.

**Issued by:** Auditor-General of South Africa

**Contact:** Africa Boso • (012) 422 9880 • [Africab@agsa.co.za](mailto:Africab@agsa.co.za)



**Follow the AGSA on Twitter:** [https://twitter.com/AuditorGen\\_SA](https://twitter.com/AuditorGen_SA)

**Media note:** The *Consolidated general report on the MFMA local audit outcomes* with all provincial highlights are available on [www.agsa.co.za](http://www.agsa.co.za).

**About the AGSA:** The AGSA is the country’s supreme audit institution. It is the only institution that, by law, has to audit and report on how government is spending taxpayers’ money. This has been the focus of the AGSA since its inception in 1911 – the organisation celebrated its 100-year public sector auditing legacy in 2011.