1 Executive summary

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The 2014-15 general report highlighted the significant progress made since 2010-11 in improving the audit outcomes in local government, but the rate of improvement was very marginal and limited in 2015-16.

The accountability that the municipal leadership must take for their actions, decisions and policies (including being answerable to the community) is critical for financial and performance management as well as respect for the law in local government. However, the limited improvement in audit outcomes over the past year shows that accountability for these important functions is not as strong as it should be. The focus of many municipal leaders was on the **local government elections** and important interventions to address vacancies and instability as well as poor control environments were postponed with the view that it would receive attention by the new administration or that the amalgamation as a result of the **re-demarcation of municipal boundaries** would address it.

Furthermore, the 2016-17 audit outcomes can be negatively affected if the new administration ‘disowns’ the audit outcomes of the previous years and does not follow through on the commitments made by their predecessors to improve audit outcomes. We call on the municipal leadership to ensure that accountability is given the highest priority from the start. Hence, the **central theme of this report is accountability**.

The key drivers of **internal control**, being leadership, financial and performance management as well as governance, had shown minimal improvement since the previous year. This slow response by the leadership to our consistent messages over the years to improve internal controls and address risks, was the main **root cause of poor audit outcomes**. Continued vacancies and instability in key positions as well as inadequate consequences for poor performance and transgressions further contributed to these outcomes.

As a result of these root causes not being addressed, there was **limited improvement in the audit outcomes of municipalities**, with 15% improving, 13% regressing and 67% remaining unchanged. The number of municipalities with clean audit opinions decreased, which included two metros that lost their clean audit status. Clean audit opinions represented only 19% of the total local government expenditure budget.

The audit outcomes of municipalities in **the Eastern Cape, Limpopo and Mpumalanga showed momentum in the right direction**, with the Eastern Cape showing the greatest improvement. The improvements in the Eastern Cape can be attributed to improved record keeping, the support provided by the provincial treasury and the provincial department responsible for cooperative governance (provincial Cogta), the leadership attending to audit recommendations, the implementation of the minimum competency levels, and the use of consultants. The improvements in Limpopo were as a result of increased focus to resolve audit findings in response to a strong stance taken by the premier that steps will be taken against municipal managers if audit outcomes are poor. In Mpumalanga, strong leadership, accountability and good human resource (HR) management at an increased number of municipalities had the desired effect.

The **Western Cape** continued with setting the pace by increasing their clean audit opinions to 80% of their municipalities. The focused interventions and support by the provincial leadership through the premier’s coordinating forum, operation clean audit and the municipal governance review and outlook process continued to bear fruit. Although **Gauteng** continued to perform well and was the only province where 100% of the municipalities received unqualified audit opinions on their financial statements, only Midvaal could hold on to its clean audit status. Not paying sufficient attention to supply chain management (SCM) and performance reporting led to three municipalities losing their clean audit status of the previous year.

After a notable improvement in 2014-15, the audit outcomes of **KwaZulu-Natal showed a significant regression** this year. Instability and vacancies in key positions, coupled with the lack of accountability, internal control failures related to compliance with key legislation that were not adequately monitored as well as the leadership’s slow response to recommendations made by internal audit units and audit committees, contributed to the regression at 14 municipalities.

The provinces with the **poorest outcomes** (based on the number of municipalities with disclaimed and adverse opinions or outstanding audits) were **North West** (35%), **the Northern Cape** (31%) and **the Free State** (29%).

There was little improvement in these provinces. Focused political will and a considerable investment in ensuring that the basics are done right are required to create a baseline from which accountability can be restored and strengthened.

The outcomes in the three main areas that we audit are as follows:

- The **audit opinions on the financial statements only slightly improved** from 60% to 62% unqualified opinions, while disclaimed and adverse opinions decreased from 13% to 10%. The revised Medium-Term Strategic Framework (MTSF) targets of 65% unqualified opinions, 20% qualified opinions and a maximum of 15% disclaimed or adverse opinions by 2018-19 can therefore be achieved. Municipalities continued to **rely on consultants**, at a cost of R838 million (2014-15: R823 million), to prepare financial statements and underlying records, and **on auditors** to identify material misstatements to be corrected. Only 31% (rather than the reported 62%) of municipalities would have received an unqualified audit opinion had we not identified the material misstatements and allowed them to make corrections. We found that at 130 municipalities (57%), 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 consultants. This remains a concern regarding the effective use of such consultants. Furthermore, the poor quality of the financial statements submitted for auditing resulted in increased audit time and cost.

  We are further concerned about the readiness of municipalities to **implement the classification framework of the Municipal Regulations on a Standard Chart of Accounts (mSCOA)** from 1 July 2017 and have shared these concerns with the National Treasury. Slow progress is being made by municipalities in preparing for the implementation – we assessed that the readiness of 73% of the municipalities was of concern while intervention was required at 11%. Various challenges, including those relating to skills, system readiness and funding, need to be addressed to ensure that the implementation does not affect the ability of municipalities to produce reliable financial statements in 2017-18.
- The audit area that showed the **greatest improvement was the quality of performance reports**, with the number of municipalities with no material findings in this regard increasing from 38% to 47%. Only 31% of municipalities would have had this positive outcome had we not identified the material misstatements and allowed them to make corrections. The increased quality of this important service delivery accountability mechanism is encouraging, but a lot of improvement is still needed. The usefulness of the information in these reports significantly improved (with the number of municipalities with findings decreasing from 45% to 38%), but almost half of the municipalities still struggled to report reliable information on service delivery.
- There was a **slight regression in the compliance with key legislation**, with the number of municipalities with no material findings decreasing from 20% to 18%. The lapse in oversight and controls in the area of compliance was evident in a number of areas, including SCM and consequence management, leading to increased irregular expenditure.

Irregular expenditure had increased by just over 50% since the previous year to R16,81 billion – the highest since we started tracking the values. The amount could be even higher, as a third of the municipalities disclosed that the full amount was not known and 24% were qualified as the amount they disclosed was incomplete. The top 10 contributors to irregular expenditure were responsible for 42% of the irregular expenditure – the majority of which involved water and sanitation infrastructure projects and grant money. There is thus a need for increased oversight of this portfolio, which should be given priority attention.

The irregular expenditure does not necessarily represent wastage or mean that fraud has been committed – this needs to be confirmed through investigations to be done by the council – but losses could already have arisen or may still arise if follow-up investigations are not undertaken. The track record of local government in **dealing with irregular expenditure** and ensuring that there is accountability is poor. The year-end balance of irregular expenditure that had accumulated over many years and had not been dealt with (through recovery, condonement or write-off) was R41,7 billion. The poor follow-up was not limited to irregular expenditure – 54% of the municipalities that incurred unauthorised, irregular and/or fruitless and wasteful expenditure in 2014-15 had not completed all investigations by the end of 2015-16.

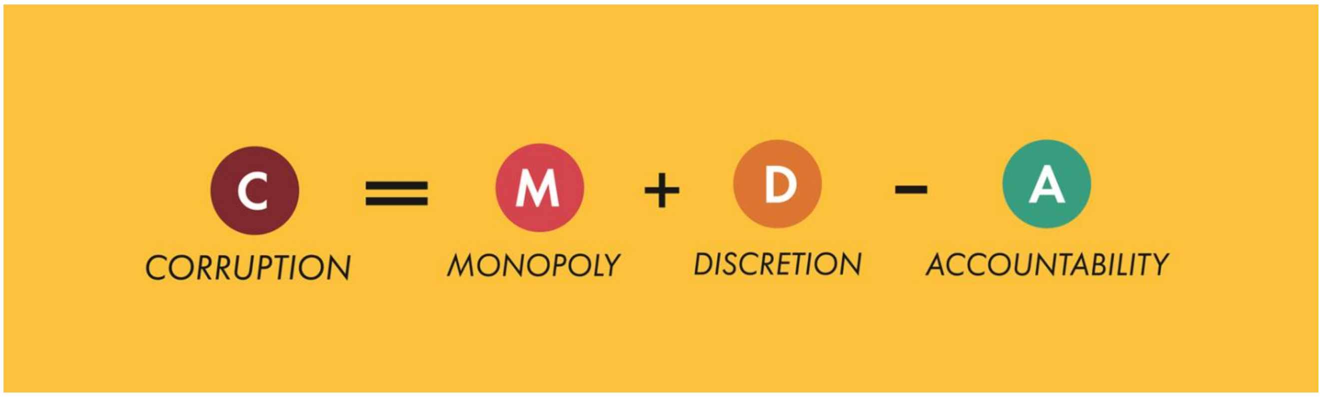
The significant increase can be **attributed overall to a weakening in SCM** at municipalities, particularly in the areas of competitive bidding (46%) and obtaining three quotations (56%), which led to irregular expenditure.

The management of contracts also regressed (44%) and there had been no improvement in addressing the concerns we have raised year after year about contracts being awarded to employees, councillors, their families and other state officials as well as documents going missing when we want to audit a procurement process. Municipalities were also dragging their feet in preparing for the implementation of the **SCM reforms** introduced by the National Treasury, which include a central supplier database and the eTender portal. Although these reforms should have been implemented from 1 July 2016, 63% of municipalities either had not started using the database or portal or had not updated their SCM policies by then.

Last year, we reported 1 648 instances of suppliers submitting false declarations of interest as part of the procurement processes, but 47% of the municipalities did not investigate any of the cases we reported to them – this year, we reported 2 015 instances. Instances of employees not declaring interests had an even lower investigation rate, with 64% of the municipalities not investigating any of the cases. In 2015-16, we reported **poor and non-compliant consequence management practices** at 61% of the municipalities – an increase from the 53% in the previous year.

Municipalities with poor consequence management practices are often prone to corruption or fraud, as a result of municipal officials not being held accountable, as illustrated in the figure below.

Figure 1: Corruption formula



If a person has monopoly over goods or services and has the discretion to decide whether someone gets such goods or services or how much someone receives, and there is no accountability whereby others can see what that person is deciding, we will tend to find corruption.

Fruitless and wasteful expenditure was 21% lower in 2015-16 than in the previous year at R901 million. **Unauthorised expenditure** remained almost at the same level as in the previous year at R12,77 billion. In total, 55% of the overspending related to non-cash items – in other words, estimates of depreciation or impairment that were not correctly budgeted for. It is important for municipalities to correctly budget for these non-cash items and to show the true financial state of the municipality.

The poor quality of financial statements submitted to us for auditing and the continuing reliance on consultants for financial reporting services call into question whether municipalities' in-year reporting and management of finances are solid. Signs of **poor financial management** were apparent in the budget preparation and monitoring processes (resulting in unauthorised expenditure) and the financial viability of municipalities, which continued to weaken year on year. In 2015-16, we rated the **financial health** of 65% of the municipalities as either concerning or requiring intervention. The most concerning indicators over the past two 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 not paying or taking very long to pay their debt, and creditors not being paid on time. In total, 27% of municipalities were in a particularly **poor financial position** by the end of 2015-16, with material uncertainty with regard to their ability to continue operating in the foreseeable future.

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. Our audit of the management of the **municipal infrastructure grant** (MIG), the **urban settlement development grant** (USDG) and the **public transport network grant** (PTNG) confirmed that the funds were fully utilised and were used for their intended purpose at the vast majority of municipalities. The main concerns with the projects funded by the MIG were that the targets set for 35% of the projects were not achieved or the municipalities had not assessed their performance against the targets as well as non-compliance with SCM prescripts on 29% of the projects.

Our audits included an assessment of aspects of the provision of water and sanitation as well as road infrastructure by local government. The work on water and sanitation was an extension of the performance audit report we published in November 2016 on water infrastructure. The performance report can be found on our website at www.agsa.co.za.

Water and sanitation infrastructure projects were mostly funded by grants, which were not fully utilised at 22% of the receiving municipalities, while there were isolated cases (six) where municipalities used the grants for other infrastructure projects and even to fund operating expenditure. Our main findings were that the projects did not always address the cause of the backlog in the provisioning of water and sanitation, projects at some municipalities were running behind schedule, and non-compliance with SCM prescripts in procuring goods and services for the projects. Over half of the municipalities responsible for providing water did not have the basic policies and plans in place to ensure that **maintenance of water infrastructure** took place. At 34%, conditional assessments of the infrastructure were not done to inform maintenance plans and budgets, with 24% of municipalities not budgeting anything for maintenance. It does then not come as a surprise that 41% of municipalities experienced water losses above the norm of 30% in 2015-16 – the average water losses for these municipalities were 52%. In total, 9% did not even disclose their water losses.

Poor policies and plans as well as inadequate maintenance were also again observed at the municipalities responsible for **road infrastructure**. Just over half of these municipalities did not have policies or maintenance plans, or did not implement them. At 20%, no conditional assessment was done of the roads to inform maintenance plans and budgets.

In 2015-16, **vacancies** in the positions of municipal manager, chief financial officer (CFO) and head of the SCM unit increased, most notably those of CFOs (vacancies at 27% of municipalities). As the contracts of these key officials come to end in 2016-17, the instability created by the vacancy rate at the end of 2015-16 could increase. We call on the political leadership to carefully consider the impact of instability and a loss of skills – especially since significant progress has been made by these officials in achieving the prescribed competency levels. Other areas with regard to resource management that need attention are the **financial management capacity** of municipalities (the capacity at 52% of municipalities is of concern while urgent intervention is needed at 8%); and the **management of consultants** (poor performance management and monitoring was identified at 60% of municipalities – an increase from the previous year – while the inadequate transfer of skills was identified at almost half of the municipalities).

Information technology (IT) controls ensure the confidentiality, integrity and availability of state information, enable service delivery and promote security in local government. The strength of financial management controls is dependent on IT controls and it is thus essential for good IT governance, effective IT management and a secure IT infrastructure to be in place. Although the status of IT controls had improved since the previous year, only 18% of municipalities were assessed as having good IT controls and continued focus is needed in the areas of security management, user access management and IT continuity. The employment of a chief information officer (CIO) or IT manager with the required qualifications and experience had a positive impact at 56% of the municipalities.

The **assurance provided** by senior management, mayors, councils and municipal public accounts committees (MPACs) remained at low levels and showed little improvement in the past year, while that of municipal managers regressed. Although internal audit units and audit committees had the highest assurance levels, little progress had been made in the past year and they had little impact on the audit outcomes at more than half of the municipalities.

The **national Department of Cooperative Governance (DCoG), provincial Cogtas, treasuries and offices of the premier** are responsible to support and strengthen the capacity of municipalities.

In total, 90% did not provide the level of assurance required. The MTSF and the back-to-basics (B2B) programme placed specific responsibilities on the cooperative governance departments and treasuries, but our audits showed that the oversight and support provided by the cooperative governance departments were inadequate and the level of support at provincial level was uneven, resulting in differing outcomes and responses to the MTSF and B2B programme. National and provincial government need to pay urgent attention to our findings and the commitments they made to support local government to ensure that the goals of these initiatives are achieved.

In this report, we propose the use of the **'plan+do+check+act' cycle** (as illustrated in figure 2 below) to continuously improve the processes, outcomes and services of municipalities and thereby strengthen accountability.

Figure 2: Plan+do+check+act cycle

We provide a number of recommendations to contribute to this improvement process, of which the main ones are outlined below:

PLAN: Spend sufficient time and consult widely to clearly **define the targets** that should be achieved by the municipality in terms of audit outcomes, service delivery (including project delivery and infrastructure maintenance) and financial health using, among others, audit action plans, the new integrated development plan, service delivery and budget implementation plans, annual budgets, and maintenance and project plans. These targets should be specific, measurable, achievable, relevant and time bound. **Responsibilities** for achieving the targets should be allocated and **sufficient time and resources** should be provided to ensure that performance is managed through robust internal control and strong financial management.

DO: Good **internal control** is the key to ensuring that municipalities deliver on their priorities in an effective, efficient and economical manner, produce quality financial statements and performance reports, and comply with applicable legislation – especially in the area of procurement and contract management.

It is the responsibility of municipal managers, senior managers and municipal officials to implement and maintain effective and efficient systems of internal control; hence, is it crucial that the **key positions** of municipal manager, CFO and head of the SCM unit are filled with people with the required competencies. Stability in these positions also correlated with good audit outcomes. Municipalities with poor audit outcomes should strengthen their financial and performance management systems through ensuring that the **basics** for a good internal control environment are in place, namely effective leadership, audit action plans, proper record keeping, daily and monthly disciplines, and the review and monitoring of compliance.

CHECK: A key element of internal control is **monitoring** by the different assurance providers to ensure that internal controls are adhered to, risks are managed, and outcomes are achieved. We urge the new administration to ensure that all the assurance providers understand their roles, are equipped to perform their functions and are given the authority their role requires, and that the outcome of their monitoring and oversight is appropriately responded to.

ACT: Accountability means that those performing actions or making decisions are answerable for them, but also that there should be consequences for transgressions, lack of action and poor performance. Municipalities should implement **consequence management** for officials who fail to comply with applicable legislation, while appropriate and timely action must be taken against transgressors. A less tolerant approach should be followed by all parties, including those charged with governance and oversight, which will result in accountability being enforced and consequences instituted against those who intentionally fail to comply with legislation.

Our country's constitution stipulates that local government should provide a democratic and an accountable government for local communities. We believe that the newly elected mayors and councillors and the administration that supports them are ready to accept their responsibilities and are willing to be held accountable for the performance of the municipalities they now govern.

Leading up to the finalisation and launch of this report, engagements took place in all the provinces. These sessions were convened by the premiers with members of the executive council (MECs), mayors, municipal managers and councillors. There was overwhelming support for the key control engagements that focused on the status of accounting records. We have also undertaken to provide feedback to leadership structures on the progress (or lack thereof) achieved through these engagements. We were encouraged by the tone and undertaking to act on our recommendations and observations.

Consequences and accountability featured as prominent elements of these engagements and we trust that all those concerned will act on their commitments and help restore trust in the ability of municipalities to look after their finances well. This will enable them to progressively meet their service commitments to citizens.

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. We wish the new political leadership and administration well for the new term and encourage all stakeholders involved in local government to intensify their efforts to ensure that communities experience an improvement in the way their municipalities operate.

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