4 Status of financial management

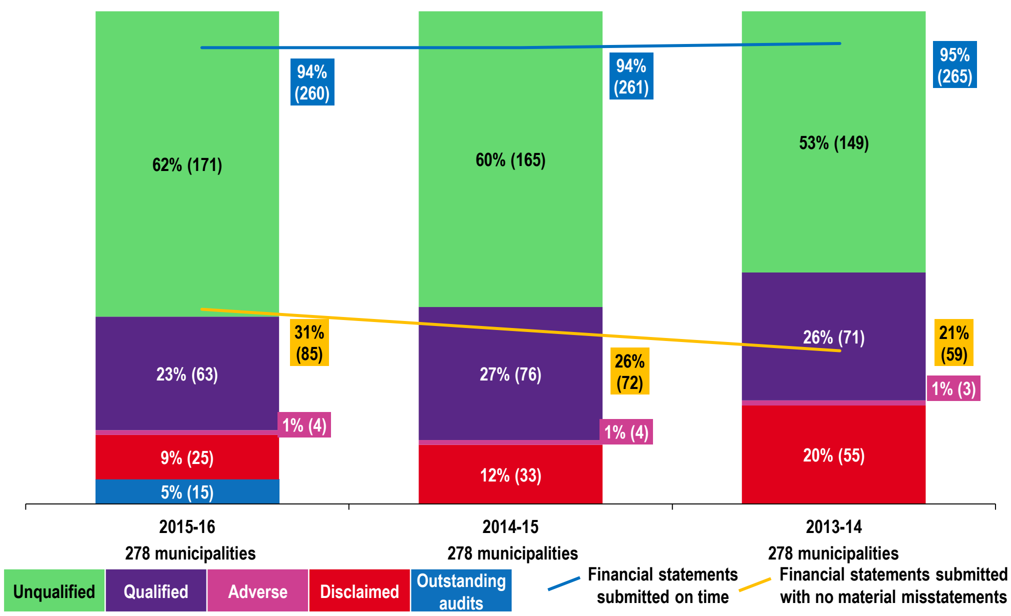
4. Status of financial management

The effect of poor internal controls on financial management is reflected and demonstrated in this section.

4.1 Financial statements

Figure 1 provides a three-year overview of audit opinions on the financial statements, the percentage of municipalities that had submitted their financial statements for auditing by the legislated date (blue line), and the percentage of municipalities that submitted financial statements that were not materially misstated (orange line).

Figure 1: Audit of financial statements



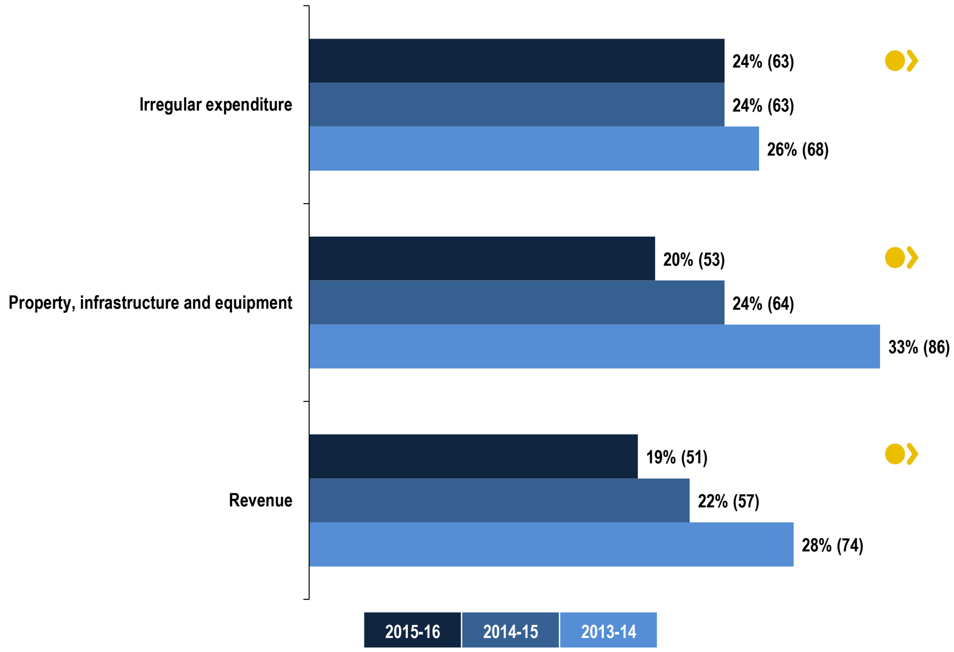
As can be seen in figure 1, 94% of the municipalities had **submitted their financial statements** for auditing by 31 August 2016 (or by 30 September 2016 in the case of consolidated financial statements), as required by legislation. Overall, the submission rate was the same as in the previous year. The rate improved in North West (from 91% to 100%), but regressed in the Free State (from 88% to 75%) due to municipalities submitting financial statements late in an attempt to improve or sustain their previous year's audit outcomes. By the cut-off date for inclusion of the audit outcomes in this report of 15 January 2017, four municipalities had not submitted their financial statements (refer to section 3.2 for more detail).

Figure 1 further shows that the **audit opinions on the financial statements** had slightly improved since the previous year to 62% unqualified opinions. Only 31% of the municipalities were able to provide us with financial statements that contained **no material misstatements** in 2015-16, which is a slight improvement from the 26% in 2014-15. This means that 86 municipalities (31%) received a financially unqualified audit opinion only because they **corrected all the misstatements** we had identified during the audit. A total of 92 municipalities were unable to make the necessary corrections to their financial statements, which resulted in qualified, adverse or disclaimed audit opinions. The main reason for not making such corrections was the unavailability of information, or incomplete information or documentation to determine the correct amounts to be reflected in the financial statements.

The slight increase in financial statements being submitted with no material misstatements was most prominent in the Eastern Cape, the Free State and the Western Cape. Although there has been a marginal increase, the **quality of submitted financial statements remains concerning** and points to a lack of implementation of basic financial disciplines such as regular reviews of financial information during the year, a lack of in-year reporting as well as reliance on auditors and consultants to identify errors in the financial statements.

Figure 2 shows the three most common financial statement qualification areas of the municipalities whose financial statements were qualified, and the progress made in addressing these areas from the previous year.

Figure 2: Three most common financial statement qualification areas



The main reason for municipalities being qualified on **irregular expenditure** was that not all irregular expenditure had been disclosed, or sufficient evidence could not be obtained that all irregular expenditure had been disclosed.

The number of municipalities qualified in this area had remained unchanged since the previous year. Gauteng was the only province with no municipalities being qualified on irregular expenditure. The Free State and the Western Cape had the lowest number and the Eastern Cape, North West and Limpopo the highest number of municipalities that were qualified on irregular expenditure in 2015-16.

The main reason for municipalities being qualified on **property, infrastructure and equipment** was that the value of assets recorded in the financial statements was incorrect, or we could not confirm the value at which these assets had been recorded.

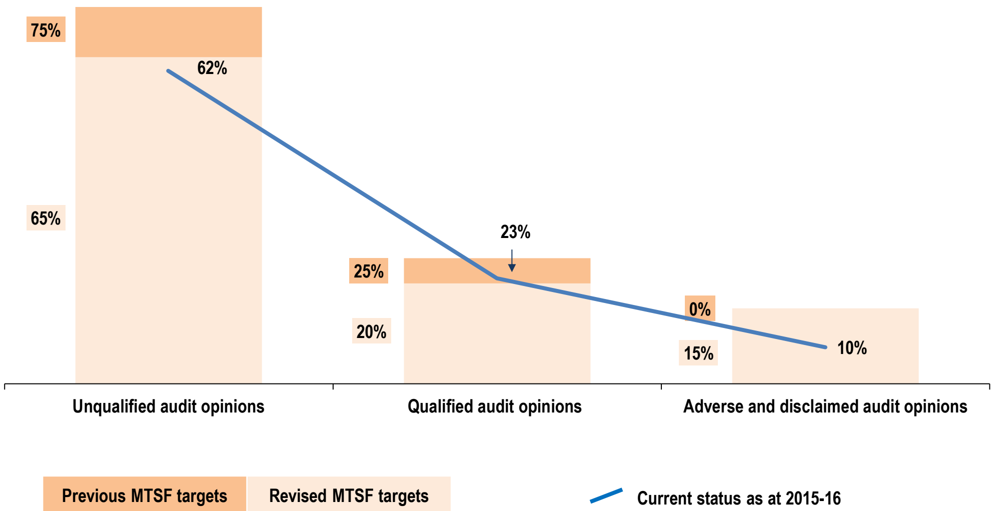
The number of municipalities whose financial statements were qualified on property, infrastructure and equipment had only slightly decreased since the previous year. We noted improvements at municipalities in the Eastern Cape, the Free State, Gauteng and North West. The improvement at some municipalities could be attributed mainly to increased reviews and monitoring of action plans addressing the previous year's qualification areas as well as assistance provided by consultants. Municipalities in the Northern Cape continued to struggle, as the province again had the highest number of municipalities (14) qualified on property, infrastructure and equipment.

The main reason for municipalities being qualified on **revenue** was that they failed to disclose all the revenue earned in their financial statements, disclosed revenue that was not earned, or could not submit sufficient evidence that all the revenue had been disclosed.

The number of municipalities qualified in this area had slightly decreased since the previous year. The qualifications were most common in North West (14 municipalities – an increase from the previous year) and the Northern Cape (11 municipalities). The municipalities in the Eastern Cape, Gauteng and Mpumalanga improved in this area – mainly due to the appointment of consultants to assist in addressing prior year qualifications.

Figure 3 shows the government's previous and revised **MTSF targets** for improving audit outcomes in pursuit of sound financial and administrative management compared to the current audit outcomes. The ministers responsible for finance and for cooperative governance are in charge of the actions and outcomes in this area, while the DCoG's **B2B strategy** contains a further commitment in this regard.

Figure 3: Current audit outcomes positioned against Medium-Term Strategic Framework targets



During 2013-14, chapter 9 of the MTSF included the baselines for audit outcomes (based on the interim audit outcomes during May 2014) and the MTSF targets for 2019 as follows:

1. Baseline set at 50% unqualified audits; 2019 target set at a minimum of at least 75% of municipalities with unqualified audit opinions.
2. Baseline set at 25% qualified audits; 2019 target set at a maximum of 25% municipalities with qualified audit opinions.
3. Baseline set at 20% adverse and disclaimed audit opinions; 2019 target set at no municipalities with adverse and disclaimed audit opinions.

New targets were set in the revised chapter 9 of the MTSF to increase the number of municipalities that have unqualified audit opinions to at least 65%, decrease the number of municipalities that have qualified audit opinions to below 20%, and decrease the number of municipalities that have adverse and disclaimed audit opinions to below 15%. As illustrated in figure 3, these targets are in reach with 62% unqualified audit opinions, 23% qualified audit opinions and 10% adverse and disclaimed audit opinions. However, the instability caused by changes in the administration and the amalgamation of some municipalities as well as the introduction of mSCOA (as further detailed in section 4.5) could still have a negative impact.

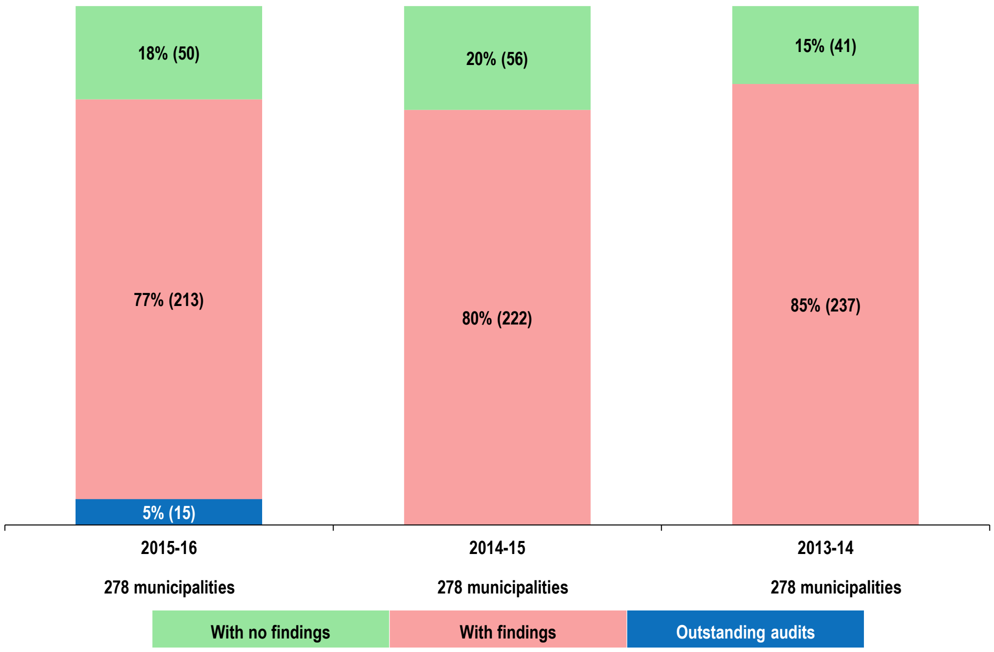
We again raise a **warning signal** that continued reliance on the auditors to identify corrections to be made to the financial statements to obtain an unqualified audit opinion is not a sustainable practice. Over the years, this has placed undue pressure on the audit teams to meet legislated deadlines for the completion of audits, with an accompanying increase in audit fees. The over-reliance on consultants is a further warning signal of a lack of capacity and skills in local government to produce unqualified financial statements. Refer to section 6.2 for further details on the extent of the use of consultants.

A Annexure 1 lists all auditees and the areas qualified.

4.2 Compliance with key legislation

Figure 1 depicts the number of municipalities that had material findings on compliance over the past three years.

Figure 1: Municipalities with findings on compliance with key legislation



For completed audits, the number of municipalities with **material findings had slightly increased** since the previous year from 79% to 81% – the increase was most evident at district municipalities (from 61% to 66%) and metros (from four to six). The compliance outcomes for municipalities in the Eastern Cape, Mpumalanga and the Western Cape slightly improved, but those in Gauteng and KwaZulu-Natal regressed. The reasons for the regressions were the slow response and lack of accountability by senior management to address internal control deficiencies and to implement action plans. In addition, municipalities did not have mechanisms to identify applicable legislation and changes thereto or processes to ensure the monitoring of compliance.

Our audits in 2015-16 did not include an assessment of the financial impact of the non-compliance by municipalities. Based on the nature of the compliance findings, however, we determined that 200 (94%) of the municipalities with material findings on compliance in 2015-16 had **findings with a potential negative financial impact or findings that could cause a financial loss** for the municipality or government. It is the role of municipal management and the council to investigate non-compliance and the impact thereof, which could include financial loss through excessive expenditure (uneconomical use of funds), fruitless and wasteful expenditure, lost revenue, failure to recover debt, and avoidable penalties and interest.

Figure 2 shows the compliance areas with the most material findings in the current year and the progress made in addressing these from the previous year.

Figure 2: Most common areas of non-compliance

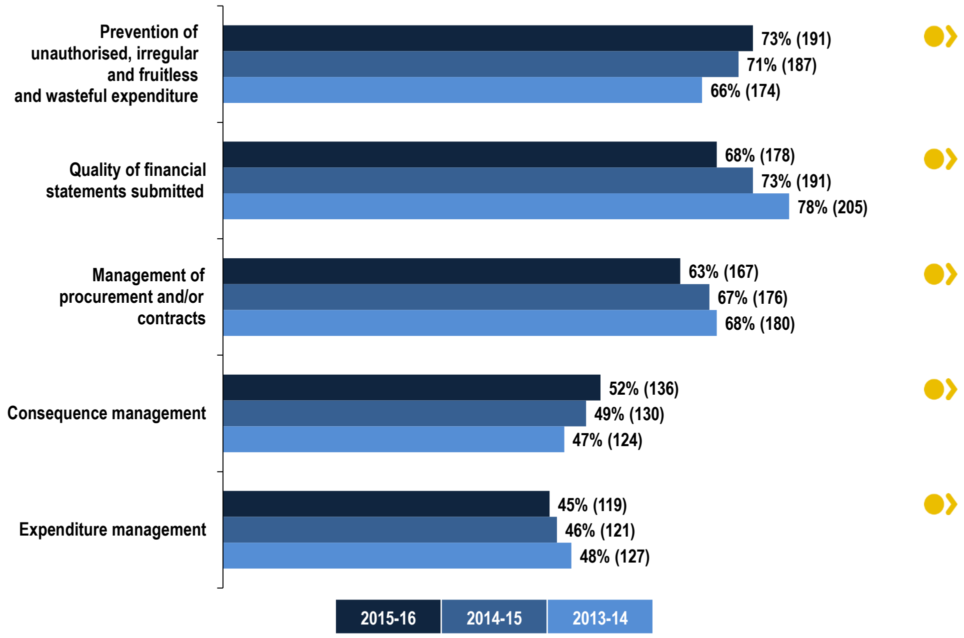


Figure 2 illustrates that over the past three years, the prevention of unauthorised, irregular as well as fruitless and wasteful expenditure, material misstatements in submitted financial statements and the management of procurement and contracts have consistently been the areas in which we raised the most compliance findings.

There had been a slight regression in the **prevention of unauthorised, irregular and fruitless and wasteful expenditure** from the previous year. Sections 4.2.1 to 4.2.3 provide more information on the movements in this area.

We report the poor quality of the financial statements we receive in the audit reports of some auditees as a material finding on compliance, as it also constitutes non-compliance with the Municipal Finance Management Act (MFMA). The finding is only reported if the financial statements we received for auditing included **material misstatements** that could have been prevented or detected if the auditee had an effective internal control system. We do not report a finding if the misstatement resulted from an isolated incident or if it relates to the disclosure of unauthorised, irregular or fruitless and wasteful expenditure identified after the financial statements had been submitted.

Slightly fewer municipalities than in 2014-15 had material findings on compliance with legislation in respect of **procurement and contract management** (also referred to as SCM). Section 4.2.1 provides more information on the findings and movement in this area.

Legislation is clear on the **consequences of non-compliance with legislation** and the steps to be taken to deal with such transgressions. Figure 2 indicates a slight increase in the number of municipalities with non-compliance in this area since 2014-15. The most common finding in 2015-16 was that irregular expenditure was not investigated to determine if any person is liable for the expenditure, which was the case at 117 municipalities. Of these municipalities, 91 (78%) also did not investigate unauthorised as well as fruitless and wasteful expenditure to determine if any person is liable for the expenditure. Section 4.2.4 provides further details on consequence management.

Municipalities continued to struggle with **expenditure management**. The most common finding was that municipalities did not pay creditors within 30 days or an agreed-upon period at 41% of the municipalities, which is a slight improvement compared to the previous year's 44%. We provide more information in section 4.3 on the indicators of financial health of municipalities.

4.2.1 Irregular expenditure caused by weaknesses in supply chain management

Irregular expenditure

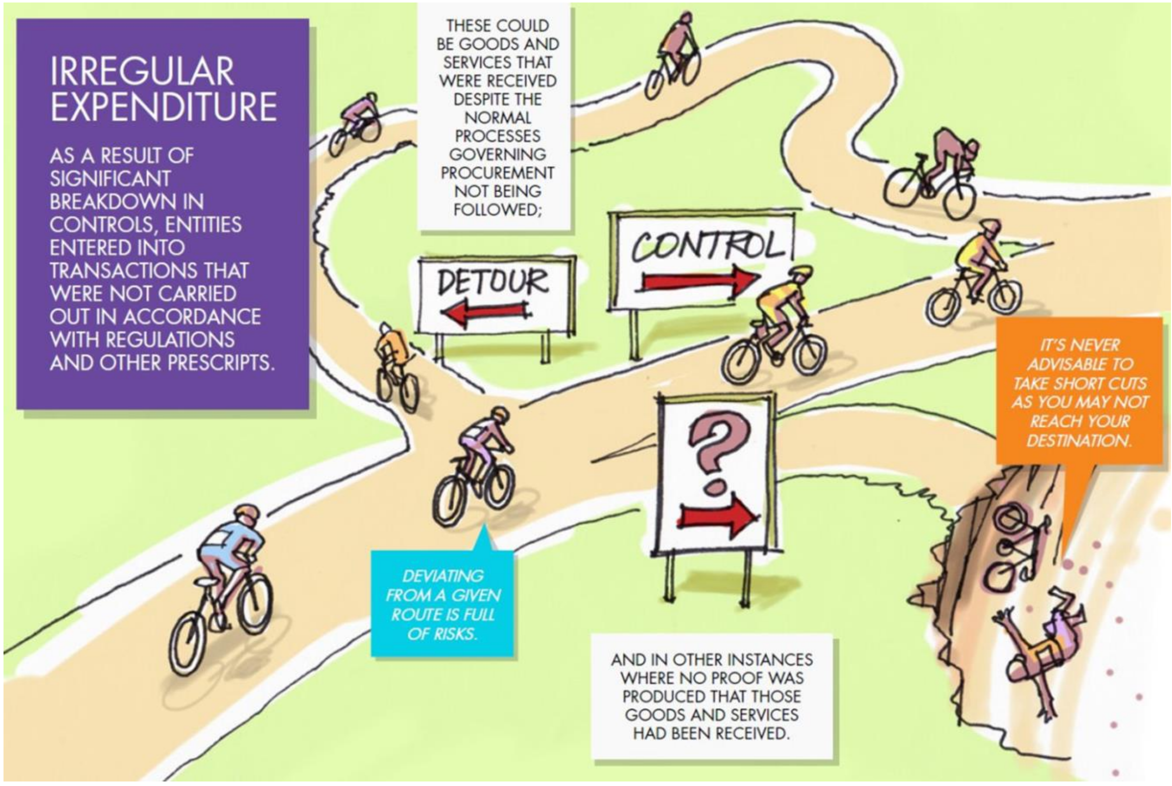
Irregular expenditure is expenditure that was **not incurred in the manner prescribed by legislation**; in other words, somewhere in the process that led to the expenditure, the municipality did not comply with the applicable legislation.

Such expenditure does **not necessarily mean that money had been wasted or that fraud had been committed**. It is an indicator of non-compliance in the process that needs to be investigated by the council to determine whether it was an unintended error, negligence or done with the intention to work against the requirements of legislation. Such legislation requires, for example, that procurement should be fair, equitable, transparent, competitive and cost-effective.

Through council's **investigation**, it is also determined who is responsible for the non-compliance and what its impact was. Based on the investigation, the next steps are determined. One of the steps can be condonement if the non-compliance had no impact and negligence was not proven. Alternatively, if negligence was proven, the steps can be disciplinary action, recovery of any losses from the implicated officials, or even cancelling a contract or reporting it to the police or an investigating authority.

Figure 1 illustrates that irregular expenditure can be as a result of a 'detour', meaning that the transactions were not in accordance with legislation but goods and services were received and there were no losses or fraud. However, such non-compliance can still be an indicator of more serious weaknesses.

Figure 1: Illustration of irregular expenditure

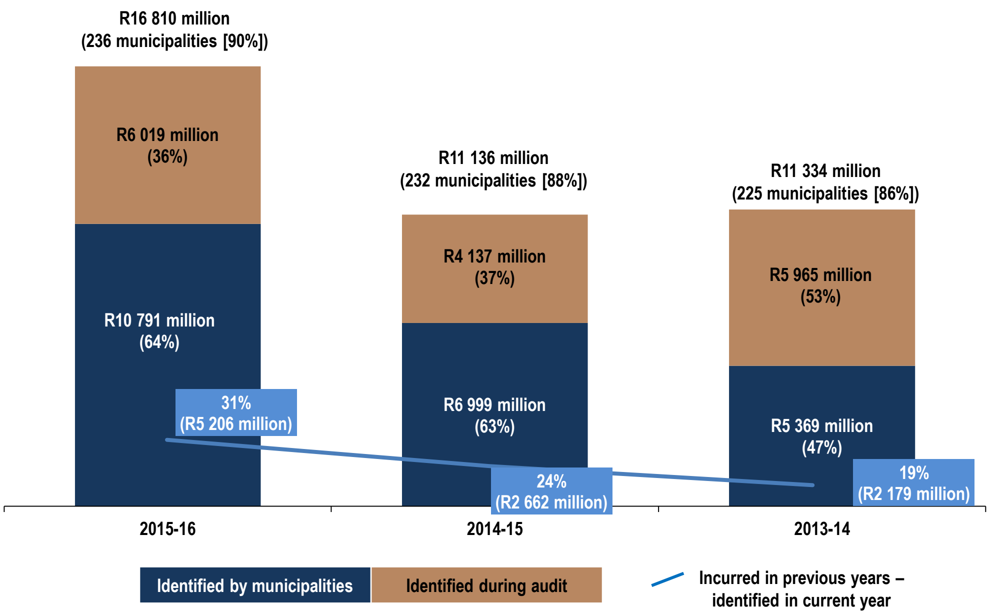


The MFMA is clear that **municipal managers are responsible** for preventing irregular expenditure. It also stipulates the process to be followed when it does occur, as described above.

In order to promote transparency and accountability, municipalities **must disclose all irregular expenditure identified (whether by the municipality or through the audit process)** in their financial statements and detail how it was resolved; in other words, how much was investigated, recovered or condoned.

Figure 2 shows the three-year trend in irregular expenditure based on the amounts disclosed in the financial statements of the municipalities. It also indicates the percentage of irregular expenditure identified by municipalities versus that identified by the audit process as well as the proportion of irregular expenditure disclosed that had been incurred in previous years (blue line).

Figure 2: Three-year trend in irregular expenditure



As can be seen in figure 2, **irregular expenditure had increased by 51%** (R5 675 million) from the previous year – the irregular expenditure in 2015-16 was the highest since we started tracking the values. The number of municipalities incurring such expenditure had increased to 236. A total of 217 (92%) of these 236 municipalities had **also incurred irregular expenditure in the previous year**.

Municipalities in the Eastern Cape, North West, KwaZulu-Natal and Mpumalanga were the **main contributors to the significant increase in irregular expenditure**. These provinces also had the highest amounts of irregular expenditure in 2015-16, as indicated below:

- Eastern Cape – R5 657 million (increased by 60%)
- North West – R2 520 million (increased by 117%)
- KwaZulu-Natal – R2 361 million (increased by 50%)
- Mpumalanga – R2 279 million (increased by 162%)

Figure 2 further shows that 69% of the irregular expenditure was as a result of non-compliance in the current year, but 31% of the irregular expenditure was the result of **acts of non-compliance in previous years**. This is typically due to one of the following scenarios:

1. Payments were made in the current year on a contract that was irregularly awarded in a previous year – if the non-compliance was not investigated and condoned, the payments on these multi-year contracts will continue to be viewed and disclosed as irregular expenditure.
2. Non-compliance in previous years was only identified in the current year and all the related expenditure (even from the previous years) was disclosed in the current year.

If we determine that a municipality did not fully disclose all of its irregular expenditure in the financial statements, the disclosure is qualified if material. To address such a qualification, municipalities typically do a very detailed review of their processes in previous years to identify all the irregular expenditure and correctly disclose it –

as per scenario 1 above. In total, R1 206 million (2014-15: R776 million) of the irregular expenditure as shown in figure 2 was as a result of **municipalities fully recognising their previous years' irregularities to address these qualifications**. It is encouraging that the full disclosure of irregular expenditure is being addressed, as it improves transparency and accountability.

As detailed earlier on in this section, inadequate action taken by municipal managers to **prevent irregular expenditure** was one of the most common material findings on compliance. We reported the findings on compliance as material at 184 municipalities (70%) (2014-15: 177 [67%]), based on the fact that they incurred irregular expenditure in 2015-16 and the previous year, a recurrence of the transgressions that had caused the irregular expenditure, and our assessment that adequate controls and processes would have prevented it.

Figure 2 also shows that we had identified 36% of the irregular expenditure of 2015-16 during the audit process (a slight improvement from the previous year), which means that some municipalities **did not have adequate processes to detect and quantify all irregular expenditure**.

Completeness of irregular expenditure

In 2015-16, 88 municipalities (33%) disclosed in their financial statements that they had incurred irregular expenditure, but the **full amount was not known** as it was still being investigated. In 2014-15, 87 municipalities (33%) had made this disclosure.

A total of 63 municipalities (24%) were qualified on the **completeness of the disclosure** of irregular expenditure in their financial statements, both in 2015-16 and 2014-15.

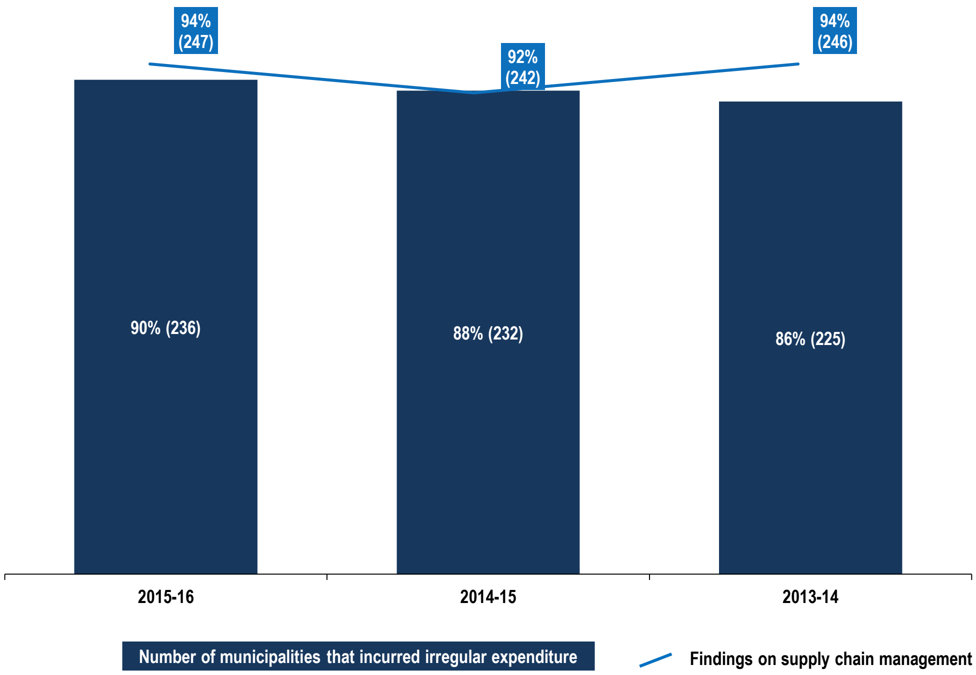
This means that the amount of irregular expenditure for 2015-16 **could have been higher** if the full amounts had been known and disclosed.

What caused these high levels of irregular expenditure?

As part of our audits of SCM in 2015-16, we tested 6 520 contracts (with an approximate value of R53 941 million) and 11 383 quotations (with an approximate value of R670 million), referred to as 'awards' in the rest of this report. Section 13.1 describes the scope of our SCM audits.

Figure 3 shows the number of municipalities where we reported findings on compliance with SCM legislation (whether reported in the audit report or only in the management report) and the number of municipalities that incurred irregular expenditure over three years.

Figure 3: Correlation between irregular expenditure and supply chain management findings



Although not all non-compliance with SCM legislation results in irregular expenditure, figure 3 **highlights the correlation between poor SCM practices and the high occurrence of irregular expenditure** at municipalities. There are slightly more municipalities with SCM findings than irregular expenditure, as – typically – SCM findings such as inadequate measures to monitor the performance of contractors would not result in irregular expenditure.

In total, **R16 523 million (98%) of the irregular expenditure in 2015-16 was as a result of non-compliance with SCM legislation**. The following were the main areas of SCM non-compliance as disclosed by the municipalities in their financial statements, with an indication of the estimated value of the irregular expenditure:

- Procurement without a competitive bidding or quotation process – R6 931 million (42%) (2014-15: 31%, R3 279 million)
- Non-compliance with procurement process requirements – R8 595 million (52%) (2014-15: 62%, R6 661 million)
- Non-compliance with legislation relating to contract management – R997 million (6%) (2014-15: 7%, R784 million).

(We discuss the typical findings in these areas later on in this section.)

The **significant increase** in irregular expenditure from the previous year can be attributed overall to a weakening in SCM at municipalities, in particular in the areas of competitive bidding and obtaining three quotations, as detailed further on in this section. In addition, instability or vacancies in senior management positions, SCM non-compliance resulting from the centralisation or outsourcing of procurement to implementing agents, and inappropriate discretion by management all played a major role in the significant increase in irregular expenditure.

Table 1 shows the municipalities that were the **main contributors (42%) to irregular expenditure in 2015-16**. The corresponding figures for 2014-15 are shown in *italics*.

Table 1: Highest contributors to irregular expenditure

Municipality	Amount (million)	Nature
OR Tambo District (EC)	R1 569 *(2014-15: R94)*	The irregular expenditure related mainly to various awards for water and sanitation projects, e.g. the Flagstaff sewer rectification project and the Tsolo wastewater treatment project. At the Tsolo wastewater treatment project, the irregular expenditure of R74,1 million was due to inappropriate reliance on SCM regulation 32 that allows participation in a contract arranged by another organ of state. The grant portion of irregular expenditure was approximately R39,58 million (3%).
Nelson Mandela Bay Metro (EC)	R1 286 *(2014-15: R1 348)*	The irregular expenditure included two awards for housing developments amounting to R216 million and various awards for sewerage infrastructure projects and water projects, e.g. the Fish Water Flats wastewater contract treatment works project and the tri-annual contract relating to construction. The SCM failures in this regard included awards to suppliers owned or managed by state employees as well as inappropriate deviations from the SCM process. The grant portion of irregular expenditure was approximately R939 million (73%).
Ngaka Modiri Molema District (NW)	R912 *(2014-15: R56)*	Payments were made on multi-year contracts that had previously been identified as irregular. A significant part related to the construction of water and sanitation infrastructure assets funded from the MIG.
Mbombela (MP)	R755 *(2014-15: R107)*	Multiple contracts were extended even though it was not impractical to invite competitive bids. A total of R26 million related to irregular expenditure funded by grants.
City of Tshwane Metro (GP)	R653 *(2014-15: R1 010)*	The expenditure mostly related to a Wi-fi contract (R293 million) where the supplier was appointed without following competitive bidding processes. A BRT tender (R189 million) was also awarded to a contractor not qualified to deliver the service. In total, R517 million (79%) related to irregular expenditure funded by grant money.
Bushbuckridge (MP)	R570 *(2014-15: R72)*	The irregular expenditure was mainly due to various awards that did not comply with SCM legislation, including water and sanitation projects, electrification of villages, provision of accommodation for councillors (e.g. advance rent payments), and road infrastructure (e.g. paving of internal streets – Mkhuhlu phase I(V)(B)). In total, R454 million (80%) related to irregular expenditure funded by grants.
Alfred Nzo District (EC)	R405 *(2014-15: R188)*	The expenditure mostly related to water supply or infrastructure projects, e.g. the Matatiele water supply scheme project amounting to R34,6 million, where the tender was not advertised and the winning bidder did not supply a tax clearance certificate. Approximately 18% (R71,9 million) of the irregular expenditure related to grants.

Municipality	Amount (million)	Nature
Buffalo City Metro (EC)	R370 *(2014-15: R479)*	The irregular expenditure related mostly to the building of the Nompumelelo community hall (R2,5 million) and the upgrading of internal roads (R222,5 million). In neither of these projects, a competitive bidding process had been followed. The estimated value of irregular expenditure where grant money was used, was R160 million (43%).
uThukela District (KZN)	R304 *(2014-15: R324)*	The expenditure was mainly due to non-compliance with SCM legislation on various awards, which included water and sanitation projects, project management services (e.g. Agri Park) as well as the compilation of asset registers and financial statements, which were mostly multi-year contracts. The previous management was dismissed due to fraud and corruption relating to these multi-year contracts.
Mafikeng (NW)	R304 *(2014-15: R35)*	The expenditure was due to various deviations in the procurement process, including issues with tax clearance certificates, BBBEE certificates and the calculation of preference points. The estimated value of irregular expenditure where MIG money was used, was R43 million (14%). This mainly related to projects for the upgrading of roads, including the main roads in Madibe and Mooipan.

These municipalities are among those that had incurred **irregular expenditure for the past three years**. As apparent from table 1, grant money was irregularly spent. We are also concerned about the irregular spending of money relating to water and sanitation projects by six of the top 10 contributors. Section 4.4 details findings relating to key projects funded by conditional grants, while section 5.2 includes findings on water and sanitation projects.

We did not investigate the irregular expenditure, as that is the role of the council. Through our normal audits, however, we confirmed that **goods and services were received** for R12 585 million (76%) of the R16 523 million in irregular expenditure relating to SCM compliance, despite the normal processes governing procurement not having been followed. However, we could not confirm that these goods and services had been procured at the best price and that value was received for the money spent.

Irregular expenditure incurred should be dealt with by the council. We therefore recommend that councils:

- properly investigate all instances of irregular expenditure to determine if any official is liable for the expenditure
- recover the resultant loss if the investigation determined that an official was liable, unless the council certifies it as irrecoverable and disciplinary processes follow
- condone irregular expenditure resulting from the contravention of council policies or by-laws, or request condonation from the National Treasury of contraventions of the MFMA or its regulations – only if the non-compliance had no impact or negligence was not proven
- report all cases of irregular expenditure that constitutes a criminal offence to the South African Police Service.

Supply chain management

We have been auditing and reporting on weaknesses in SCM for a number of years and our messages have been consistent on the need to pay urgent and focused attention to improving the SCM processes.

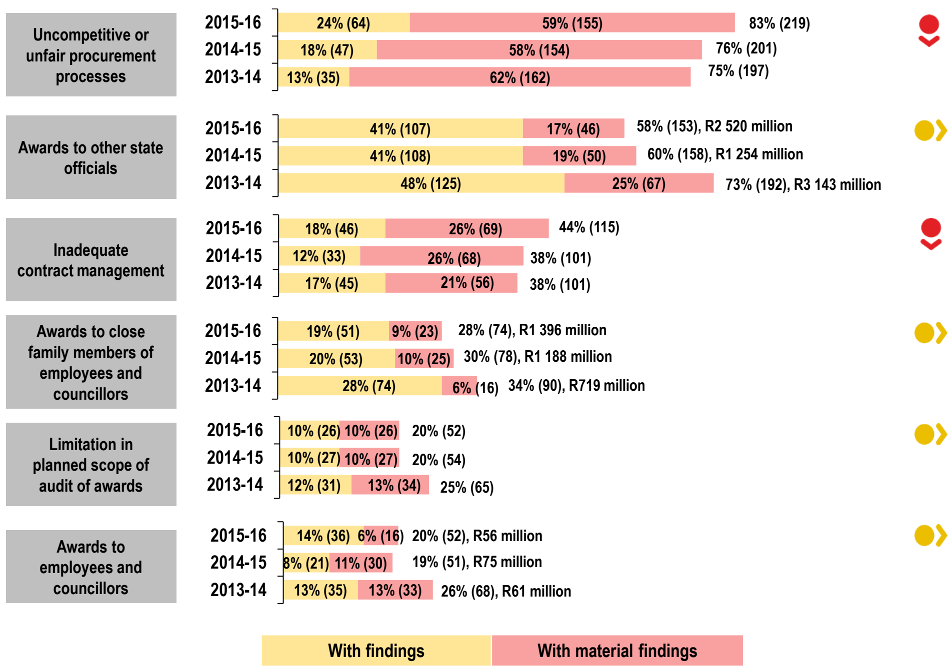
Figure 4 depicts the number of municipalities that had SCM findings and those where we have reported material findings on compliance in the audit report since 2013-14.

Figure 4: Status of supply chain management

Slightly fewer municipalities than in the previous year had no SCM findings. The Free State and KwaZulu-Natal had regressed from the previous year and only Gauteng had improved with regard to municipalities with no SCM findings. Although slightly fewer municipalities than in the previous year had material findings, it remains concerning that over 60% of the municipalities did not comply materially with SCM legislation. Although the SCM findings of 30% of the municipalities were not material enough to be reported in the audit report, the control weaknesses that allowed the non-compliance to occur should be addressed to prevent a regression in audit outcomes in future.

Figure 5 provides a three-year overview of all the SCM areas in which municipalities had findings, the number of municipalities where the findings raised were material enough to be reported in the audit report, as well as the extent of awards made to employees and close family members of employees.

Figure 5: Findings on supply chain management



The level of total SCM findings (material plus non-material findings) had shown little movement in any of the SCM areas since the previous year, except in the areas of **uncompetitive or unfair procurement processes and inadequate contract management**, which had regressed since the previous year. The remainder of this section provides more detail on the nature of the findings and the status of reforms.

Limitation in planned scope of audit

In 2015-16, we were unable to audit awards to the value of R2 765 million at 52 municipalities because the municipalities **could not provide us with evidence that awards had been made in accordance with the requirements of SCM legislation**, as the documentation either did not exist or could not be retrieved as a result of poor document management.

Table 2 lists the extent of limitations in local government over three years.

Table 2: Extent of limitations on planned audits

Province	2015-16		2014-15		2013-14		Movement - 2015-16 from 2014-15
	Number of municipalities	Amount R million	Number of municipalities	Amount R million	Number of municipalities	Amount R million	
Eastern Cape	10	1 410	15	377	19	341	
Free State	5	38	1	0	7	54	
Gauteng	1	307	4	1 250	3	85	
KwaZulu-Natal	7	447	6	183	8	191	
Limpopo	6	234	6	54	5	66	
Mpumalanga	4	40	9	653	5	186	
Northern Cape	5	5	4	13	6	31	
North West	13	284	8	299	10	440	
Western Cape	1	0	1	11	2	21	
Total	52	2 765	54	2 840	65	1 415	

While the number of municipalities where limitations were experienced in 2015-16 had decreased only slightly from the previous year, there was a more visible improvement in Gauteng, Mpumalanga and the Eastern Cape. The value of these limitations varied over the three years, as it depends on the value of the relevant contracts awarded in the year.

These limitations had the following impact:

- The procurement processes could not be audited by us, the internal auditors or investigators.
- There was no evidence that municipalities had followed a fair, transparent and competitive process for all awards. Should unsuccessful bidders request information on the process, also for possible litigation purposes, it would not be available.
- We could not determine whether these awards were irregular and, as a result, could not determine the true extent of irregular expenditure.
- Our general report, audit reports and management reports did not reflect the true extent of non-compliance with SCM, irregularities and possible fraud.
- Poor record management created an environment in which it was easy to commit and conceal improper or illegal conduct.

Awards to employees, councillors, close family members and other state officials

There had also been little movement in the number of municipalities with awards to **suppliers in which employees or their close family members had an interest** or awards to **suppliers in which other state officials had an interest**.

SCM regulation 44 prohibits the awarding of contracts and quotations to persons (employees, councillors or other state officials), or entities owned or managed by them, if they are in the service of the municipality or if they are in the service of any other state institution. Such expenditure is also considered irregular.

Suppliers owned or managed by employees of any other state institution made false declarations in awards of R1 964 million at 110 municipalities (e.g. suppliers owned by employees at a government department made a false declaration when applying for the tender at a municipality). Suppliers owned by family members of employees of the municipality also made false declarations in awards of R454 million at 29 municipalities.

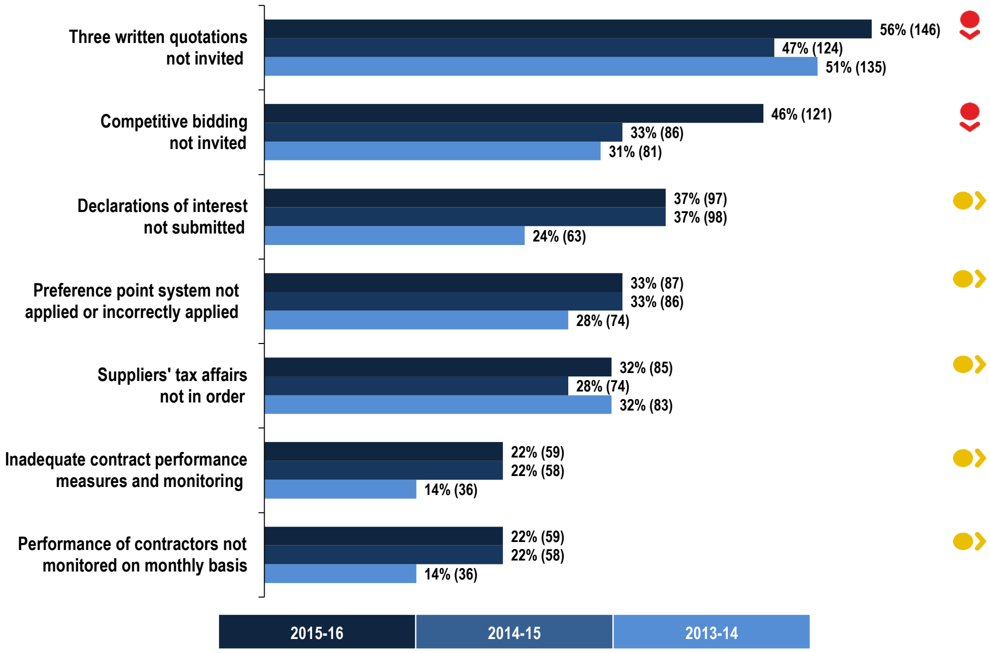
At 24 municipalities, employees failed to declare their own interest in awards of R23 million either as part of the procurement processes or through annual declarations. At 46 municipalities, employees failed to declare their family members' interest in awards of R806 million.

The possibility of undue influence cannot be discounted, especially if the person, including SCM officials, could have influenced the procurement processes for these awards, which could have created opportunities for irregularities. We again point out that a **failure by suppliers to declare the interest of employees and other state officials constitutes a fraudulent act**, which should be investigated and dealt with in accordance with legislation. Section 4.2.4 provides more information on how municipalities have dealt with this in the last three years.

Procurement processes and contract management

Figure 6 provides a three-year overview of the most common findings on procurement processes and contract management – all of which can have a potential negative financial impact. All, except the findings on inadequate performance measures and monthly monitoring of contractors, lead to irregular expenditure.

Figure 6: Most common findings on procurement processes and contract management



The most common findings for the past three years relate to **deviations from the prescribed procurement processes**. Three written quotations or competitive bids were not invited to enable the selection of a supplier based on a competitive and fair process. Although such deviations are allowed, we found that it had often not been approved; or, if approved, the deviation was not reasonable or justified.

The regression in this regard is concerning and points to a breakdown in controls, mainly caused by inappropriate management discretion (e.g. deviating from following a competitive bidding process without justifiable reason) and poor planning. In some instances, municipalities also tended to appoint service providers they knew or had used in the past by deviating from the competitive bidding process. The Preferential Procurement Regulations make provision for the promotion of local production and content. These regulations are aimed at supporting socio-economic transformation. In 2015-16, we audited whether procurement at 223 municipalities took place in accordance with legislative requirements **to procure certain commodities from local producers**. We identified non-compliance in this regard on awards amounting to R421 million at 39 (17%) of these municipalities. The provinces where we raised the most of these findings were Mpumalanga (eight municipalities), Limpopo (six municipalities) and the Eastern Cape (six municipalities). We will continue to increase our audit focus on this important government initiative.

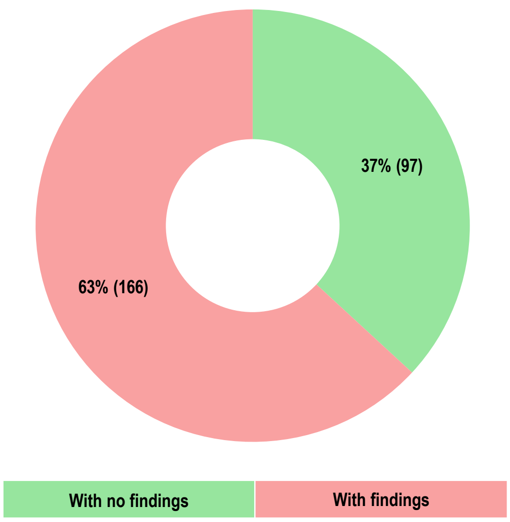
Readiness for supply chain management reforms

The National Treasury, through the Office of the Chief Procurement Officer, is accelerating reforms that will make it easy for business and government to transact and to ensure that government purchases what it needs at the right time, at the right price, in the correct quantities and delivered to the right location. These reforms include establishing the **central supplier database** of government and the **eTender portal** to be used by all organs of state.

As part of our audits, we assessed the readiness of municipalities to implement these SCM reforms. Our focus was on the use of the central supplier database and the eTender portal, which was compulsory from 1 July 2016.

Figure 7 shows the state of readiness of municipalities regarding the implementation of the SCM reforms.

Figure 7: Readiness of municipalities for supply chain management reforms



The following were the most common findings with regard to SCM reforms:

- The SCM policy at 143 municipalities (54%) was not updated to invite competitive bids through the eTender portal.
- The SCM policy at 138 municipalities (52%) was not updated to invite quotations from suppliers registered on the central supplier database.
- A total of 138 municipalities (52%) had not started inviting bids through the eTender portal as at the 2015-16 year-end.
- A total of 117 municipalities (44%) still used their own database of prospective suppliers, which was not synchronised with the central supplier database.

The SCM weaknesses require immediate and focused action to ensure that the principles of fairness, transparency, completeness, equity and cost-effectiveness in procurement processes are consistently applied, and to address the very high amounts of irregular expenditure incurred annually. As the SCM reforms were introduced to address many of the SCM weaknesses in local government, it is critical that these reforms are implemented by municipalities and monitored at provincial and national level.

A

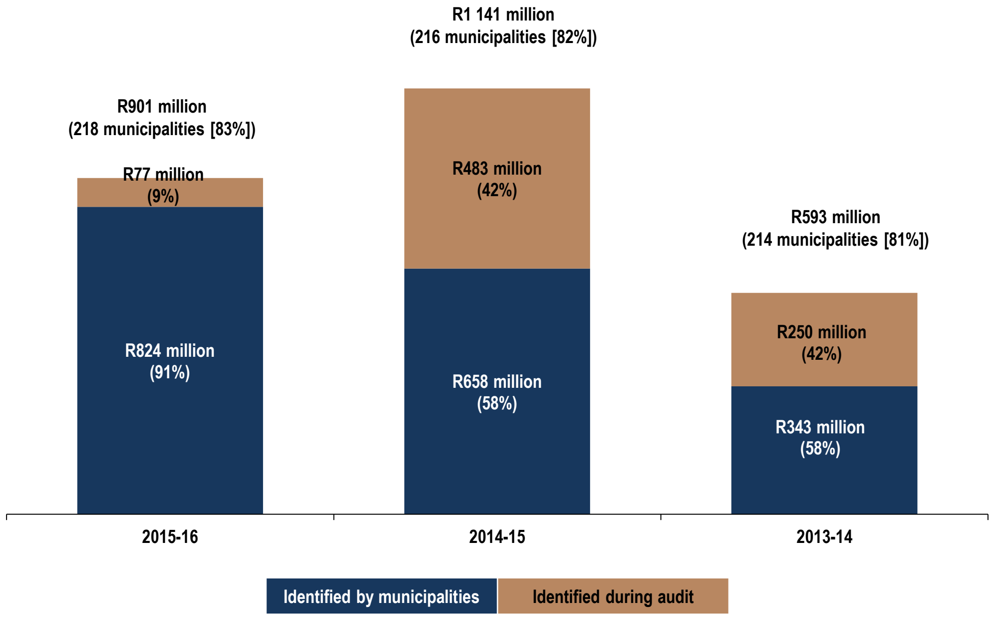
Annexure 1 shows the auditees with irregular expenditure, while annexure 2 lists those with findings on SCM.

4.2.2 Fruitless and wasteful expenditure

Fruitless and wasteful expenditure refers to expenditure that was made in vain and could have been avoided had reasonable care been taken. Such expenditure includes interest, the payment of inflated prices, and the cost of litigation that could have been avoided.

Figure 1 depicts the extent of fruitless and wasteful expenditure over the past three years and the proportion thereof that was identified during the audit and not by the municipality.

Figure 1: Three-year trend in fruitless and wasteful expenditure



As shown in figure 1, the **amount of fruitless and wasteful expenditure** had decreased by 21% since the previous year, while the number of municipalities that incurred this type of expenditure had slightly increased.

A total of 201 municipalities (92%) incurred fruitless and wasteful expenditure in both the current and the previous year, of which 136 had incurred such expenditure for the past five years.

The amount of fruitless and wasteful expenditure incurred by municipalities in the Eastern Cape, Limpopo and North West had decreased from the previous year, while the amount incurred by municipalities in KwaZulu-Natal (61%), the Northern Cape (59%) and the Western Cape (145%) had increased by more than 50% in each of these provinces.

The general **nature of the fruitless and wasteful expenditure** related to the following:

- Interest and penalties on overdue accounts and late payments – R814 million (90%) (2014-15: R638 million [56%]). The poor financial health of municipalities as further described in section 4.3 was the main contributor in this regard.
- Litigation and claims – R23 million (3%) (2014-15: R55 million [5%]).
- Other (e.g. cancellation fees for accommodation and unsuccessful implementation of software) – R64 million (7%) (2014-15: R448 million [39%]).

Of the R901 million incurred in 2015-16, only R7 million (1%) was incurred by municipalities to **avoid further fruitless and wasteful expenditure** or losses that often relate to the cost of cancelling irregular contracts or the contracts of non-performers.

The following municipalities were the **main contributors** (51%) to fruitless and wasteful expenditure in 2015-16. The corresponding figures for 2014-15 are shown in *italics*.

Table 1: Highest contributors to fruitless and wasteful expenditure

Municipality	Amount (million)	Nature
Ngwathe (FS)	R74 *(2014-15: R51)*	Payment of interest and penalties on overdue accounts and late payments.
Emalahleni (MP)	R74 *(2014-15: R95)*	In total, 99,6% of the expenditure related to interest and penalties, while the remainder related to Land Scheme Management Act expenditure.
Nelson Mandela Bay Metro (EC)	R58 *(2014-15: R423)*	A total of 47% of the expenditure related to interest and penalties, while approximately 46% related to civil claims from vehicle accidents as well as expenditure with regard to flights, accommodation and recruitment service providers.
Msukaligwa (MP)	R47 *(2014-15: R13)*	Payment of interest and penalties on overdue accounts and late payments.
Thaba Chweu (MP)	R44 *(2014-15: R36)*	Payment of interest and penalties on overdue accounts and late payments.
Nala (FS)	R39 *(2014-15: R26)*	A total of 59% of the expenditure related to interest and penalties, while approximately 41% related to completed infrastructure assets that were no longer usable.
Kouga (EC)	R35 *(2014-15: R2)*	Payment of interest and penalties on overdue accounts and late payments.
Naledi (NW)	R30 *(2014-15: R18)*	Payment of interest and penalties on overdue accounts and late payments.
Govan Mbeki (EC)	R29 *(2014-15: R28)*	Payment of interest and penalties on overdue accounts and late payments.
Lekwa (MP)	R27 *(2014-15: R25)*	Payment of interest and penalties on overdue accounts and late payments.

These municipalities are among those that had incurred fruitless and wasteful expenditure for the past three years, with Ngwathe, Nelson Mandela Bay Metro, Thaba Chweu, Nala, Kouga, Govan Mbeki and Lekwa doing so for the past five years.

As detailed earlier on in this section, **inadequate action taken** by municipal managers to prevent fruitless and wasteful expenditure was one of the most common material findings on compliance. We reported the findings on compliance as material at 144 municipalities (55%) (2014-15: 138 [52%]) based on the fact that they incurred fruitless and wasteful expenditure in the year under review as well as in previous years, a recurrence of the action that had caused the fruitless and wasteful expenditure, and our assessment that adequate controls and processes would have prevented it.

Figure 1 further illustrates that we had identified only 9% of the fruitless and wasteful expenditure amount during the audit process, which means that most municipalities had adequate processes to detect and quantify all fruitless and wasteful expenditure, as required by legislation. This is an improvement from the previous year.

Fruitless and wasteful expenditure incurred should be dealt with by the council. We therefore recommend that councils:

- properly investigate all instances of fruitless and wasteful expenditure to determine if any official is liable for the expenditure
- recover the resultant loss if the investigation determined that an official was liable, unless the council certifies it as irrecoverable and disciplinary processes follow.

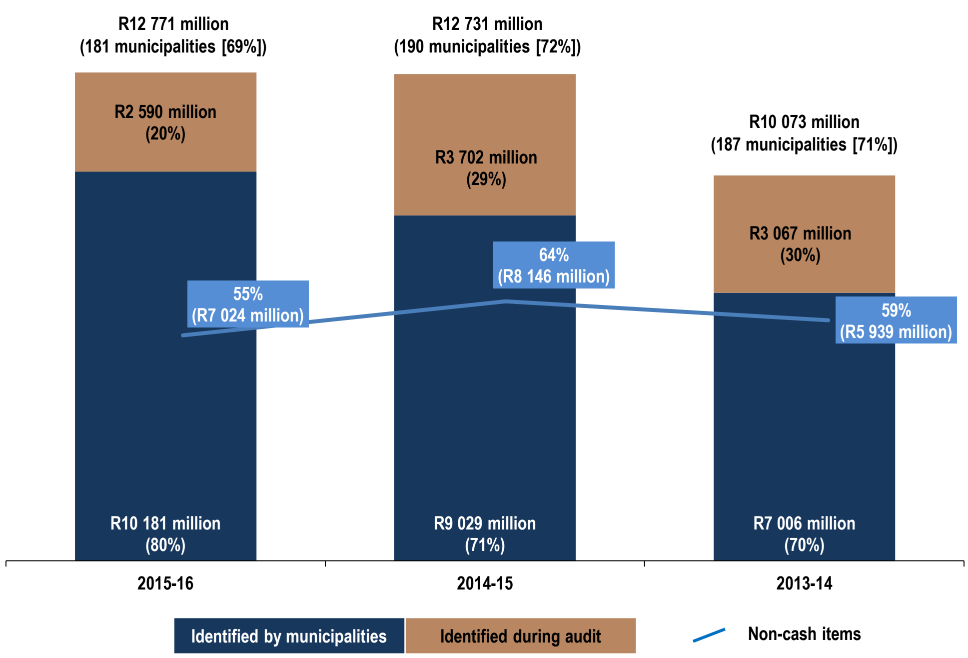
A Annexure 1 shows the auditees with fruitless and wasteful expenditure.

4.2.3 Unauthorised expenditure

Unauthorised expenditure refers to expenditure incurred by municipalities outside the budget approved by the council or not in accordance with the conditions of a grant.

Figure 1 depicts the extent of unauthorised expenditure over the past three years and the proportion thereof that was identified during the audit and not by the municipality. It further reflects the percentage of unauthorised expenditure that relates to non-cash items for the three-year period.

Figure 1: Three-year trend in unauthorised expenditure



As reflected in figure 1, the **amount of unauthorised expenditure** had remained at almost the same level as in the previous year. Despite the increase of less than 1% in the amount of total unauthorised expenditure incurred since the previous year, there was a significant increase in the amount of unauthorised expenditure incurred by municipalities in KwaZulu-Natal (43%), Gauteng (40%) and the Northern Cape (22%), which is concerning. At an overall level, this was offset by a significant decrease in the amount of unauthorised expenditure incurred by municipalities in the Western Cape (65%), the Eastern Cape (41%) and North West (30%).

A total of 158 (87%) of the 181 municipalities had also incurred unauthorised expenditure in the previous year.

Overspending of the budget or main sections within the budget was the reason for 99% (2014-15: 97%) of the unauthorised expenditure. Poorly prepared budgets, inadequate budget control and a lack of monitoring and oversight were some of the reasons for the overspending.

Municipal budgets also make provision for items that do not involve actual cash inflow or outflow. We term these **non-cash items**, which include accounting entries such as reducing the value at which assets are reflected in the financial statements (asset impairments) and providing for other types of potential financial losses. This is not actual expenditure but rather an accounting requirement that enables municipalities to assess the true value of their assets (such as equipment or debtors). It is important for municipalities to correctly budget for these non-cash items to build up reserves for the replacement of assets and to show the true financial state of the municipality.

As shown in figure 1, 55% of the overspending that had caused the unauthorised expenditure did not represent actual payments in excess of the budget, but rather these estimates that had been incorrectly budgeted for. This is a decrease when compared to the previous year. It is of concern that the budgets of some of these municipalities might have been manipulated to show a surplus by incorrectly showing the true extent of the non-cash items in the budget. At year-end these amounts are audited and are thus shown at the correct value, which then results in unauthorised expenditure.

Thirty-one municipalities (17%) incurred unauthorised expenditure of R939 million (7%) only because of such non-cash items.

The following municipalities were the **main contributors** (51%) to unauthorised expenditure in 2015-16. The corresponding figures for 2014-15 are shown in *italics*.

Table 1: Highest contributors to unauthorised expenditure

Municipality	Amount (million)	Nature
City of Tshwane Metro (GP)	R1 914 *(2014-15: R786)*	Overspending of the budget / main sections within the budget – 43% of which related to non-cash items. The expenditure can mainly be attributed to employee-related cost, debt impairment, depreciation, finance charges, bulk purchases, contracted services, transfers and grants, and losses on the disposal of property, plant and equipment.
Emalahleni (MP)	R831 *(2014-15: R233)*	A total of 98% related to overspending of the budget / main sections within the budget – 91% of which related to non-cash items. In total, R14 million of the R75 million relating to cash items was as a result of unspent grants that were not cash-backed.
Madibeng (NW)	R796 *(2014-15: R1 258)*	Overspending of the budget / main sections within the budget – 74% of which related to non-cash items. The expenditure can be attributed to depreciation, impairment, finance costs, general expenses, expenses related to contracted services, repairs and maintenance.
City of Johannesburg Metro (GP)	R693 *(2014-15: R959)*	Overspending of the budget / main sections within the budget – 68% of which related to non-cash items. Apart from non-cash items such as depreciation, the overspending can mainly be attributed to transportation-related expenses, health-related expenses, emergency services expenditure, and expenses related to group finance.
Newcastle (KZN)	R674 *(2014-15: R0)*	Overspending of the budget / main sections within the budget – 87% of which related to non-cash items. The municipality incurred unauthorised expenditure mainly as a result of bad debts written off and the revaluation of assets. The impact of this could not be accurately estimated during the preparation of the adjustment budget.
Emfuleni (GP)	R461 *(2014-15: R453)*	Overspending of the budget / main sections within the budget – 53% of which related to non-cash items. The overexpenditure can mainly be attributed to debt impairment, depreciation, personnel costs, finance costs, and general expenditure.
Vhembe District (LP)	R302 *(2014-15: R258)*	Overspending of the budget / main sections within the budget – 74% of which related to cash items (mostly repairs and maintenance) – and 26% of which related to non-cash items, such as debt impairment, depreciation and/or amortisation.

Municipality	Amount (million)	Nature
Polokwane (LP)	R287 *(2014-15: R232)*	Overspending of the budget / main sections within the budget – 100% of which related to non-cash items, such as debt impairment and fair value adjustments.
Westonaria (GP)	R269 *(2014-15: R279)*	Overspending of the budget / main sections within the budget – 91% of which related to non-cash items. This overspending can mainly be attributed to debt impairment of property rates by mines due to their objection and council not budgeting for this expenditure.
Ngaka Modiri Molema District (NW)	R252 *(2014-15: R407)*	Overspending of the budget / main sections within the budget– none of which related to non-cash items. The expenditure can be attributed to finance costs, expenses related to contracted services, general expenses as well as transfers and subsidies.

These municipalities (except for the City of Johannesburg Metro, Newcastle and Emfuleni) are among those that had incurred such expenditure for the past three years. The City of Johannesburg Metro and Emfuleni had incurred such expenditure in the past two years, while Newcastle incurred such expenditure only in the current year. The City of Tshwane Metro, Polokwane and Ngaka Modiri Molema District had incurred unauthorised expenditure for the past five years.

As detailed earlier on in this section, inadequate steps taken by municipal managers to prevent unauthorised expenditure constituted one of the most common material findings on compliance. We reported the findings on compliance as material at 145 municipalities (55%) (2014-15: 148 [56%]) based on the fact that they had incurred the same type of unauthorised expenditure in the current and previous years as well as our assessment that adequate controls and processes would have prevented it.

Figure 1 also shows that we had identified 20% of the unauthorised expenditure amount during the audit process, which means that some municipalities did not have adequate processes to detect and quantify all unauthorised expenditure. This is, however, an improvement from the previous year.

Unauthorised expenditure incurred should be dealt with by the council. We therefore recommend that councils:

- properly investigate all instances of unauthorised expenditure to determine if any official is liable for the expenditure
- recover the resultant loss if the investigation determined that an official was liable, unless the council certifies it as irrecoverable and disciplinary processes follow
- authorise it through an adjustment budget.

A

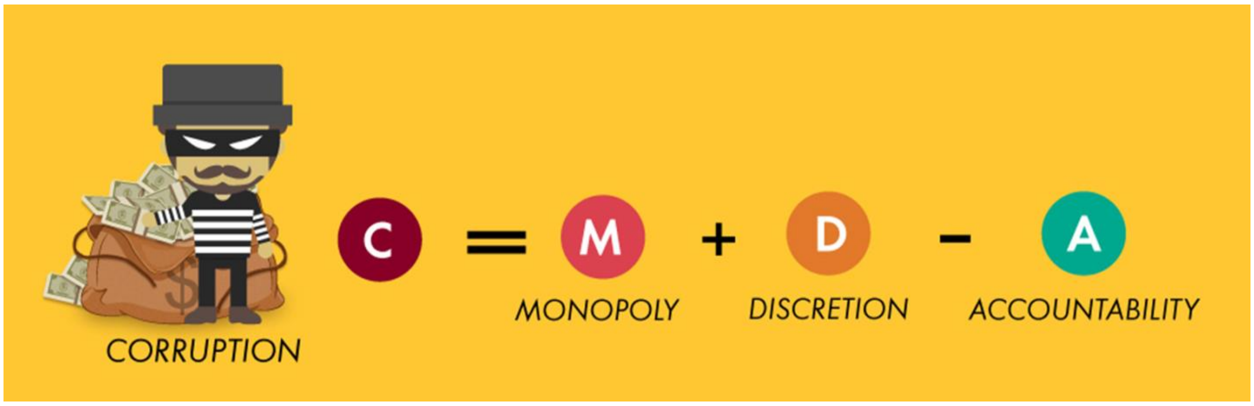
Annexure 1 shows the auditees with unauthorised expenditure.

4.2.4 *Fraud and consequence management*

The MFMA and its regulations clearly stipulate that management should investigate matters such as incurring unauthorised, irregular and fruitless and wasteful expenditure, the possible abuse of the SCM system (including fraud and improper conduct), and allegations of financial misconduct and possible fraud. Appropriate actions should be taken based on the outcomes of these investigations.

Municipalities with **poor consequence management** practices are often prone to corruption or fraud, as a result of municipal officials not being held accountable. Figure 1 below demonstrates the need for strong accountability based on a formula on corruption developed by Robert Klitgaard.

Figure 1: Corruption formula



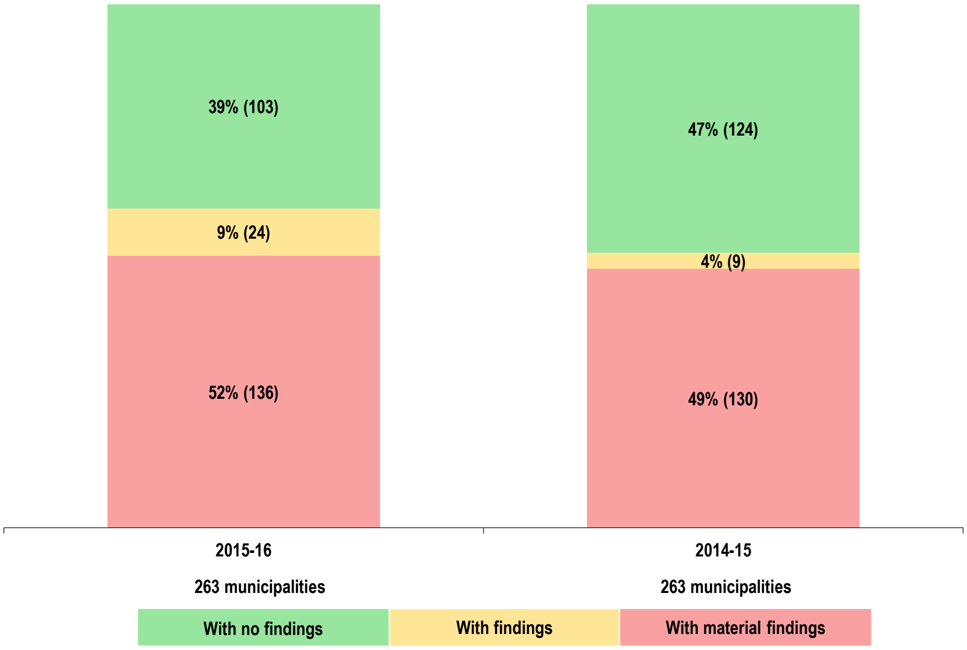
Corruption arises when officials are given sole power (**monopoly**) to make consequential decisions (**discretion**) without adequate oversight or control (**accountability**). In local government, municipalities are tasked with the responsibility of providing a number of services that cannot be provided by any other service provider, such as water and sanitation. When making financial decisions, municipalities have a certain degree of discretion. In some cases, they decided to deviate from procurement processes as a result of, for example, bad planning. Should the accountability culture in a municipality not be strong, these actions can create an environment that is conducive to corruption.

This section provides our observations and findings on how municipalities managed allegations of misconduct and fraud, and how they dealt with unauthorised, irregular as well as fruitless and wasteful expenditure.

Non-compliance with legislation on consequence management

Figure 2 shows the extent of non-compliance with legislation in respect of consequence management – ‘with material findings’ means that the non-compliance was so significant that we reported it in the audit reports of those municipalities, while ‘with findings’ means that there was non-compliance but to a lesser degree.

Figure 2: Status of consequence management



The **level of compliance with legislation on consequence management had regressed** since the previous year, mostly as a result of regressions in Mpumalanga (33%), Gauteng (25%) and KwaZulu-Natal (16%). The provinces with the highest number of municipalities with non-compliance findings in 2015-16 were the Eastern Cape (32), KwaZulu-Natal (28), North West (22) and Limpopo (19). The most common findings were the following:

- Fruitless and wasteful expenditure identified in the prior year was not investigated at 122 municipalities.
- Irregular expenditure identified in the prior year was not investigated at 120 municipalities.
- Unauthorised expenditure identified in the prior year was not investigated at 104 municipalities.

The remainder of this section provides more insights into the non-compliance and overall consequence management practices.

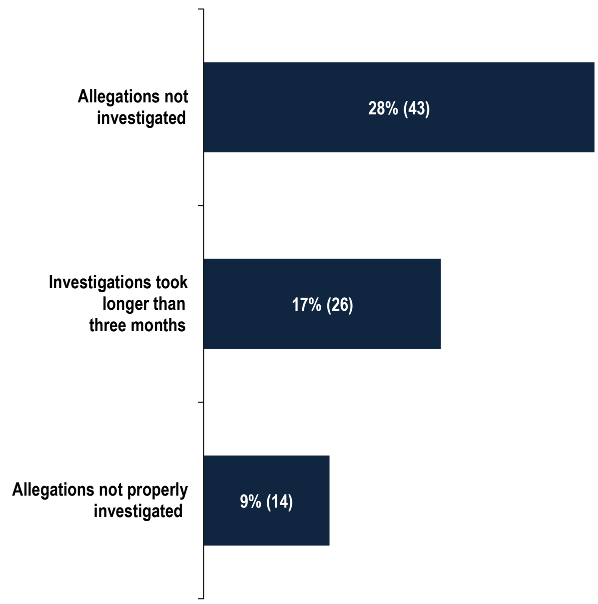
Reporting and follow-up of allegations of financial and supply chain management misconduct and fraud

Our audits showed that 38% of the municipalities **did not have all the required mechanisms for reporting and investigating transgressions or possible fraud**, such as policies, codes of conduct, fraud reporting mechanisms, and record keeping of processes. The following were the most common findings in this regard:

- A disciplinary board had not been established at 73 municipalities.
- There was no fraud hotline at 53 municipalities.
- No policies for investigations existed at 50 municipalities.

This contributed to the fact that 52% of municipalities had findings on **inadequate follow-up of allegations of financial and SCM misconduct and fraud**. Such allegations were made in the previous year at 151 municipalities where they were required to take appropriate action regarding these allegations. Figure 3 reflects our findings on how these allegations were dealt with.

Figure 3: Follow-up of allegations of financial and supply chain management misconduct and fraud



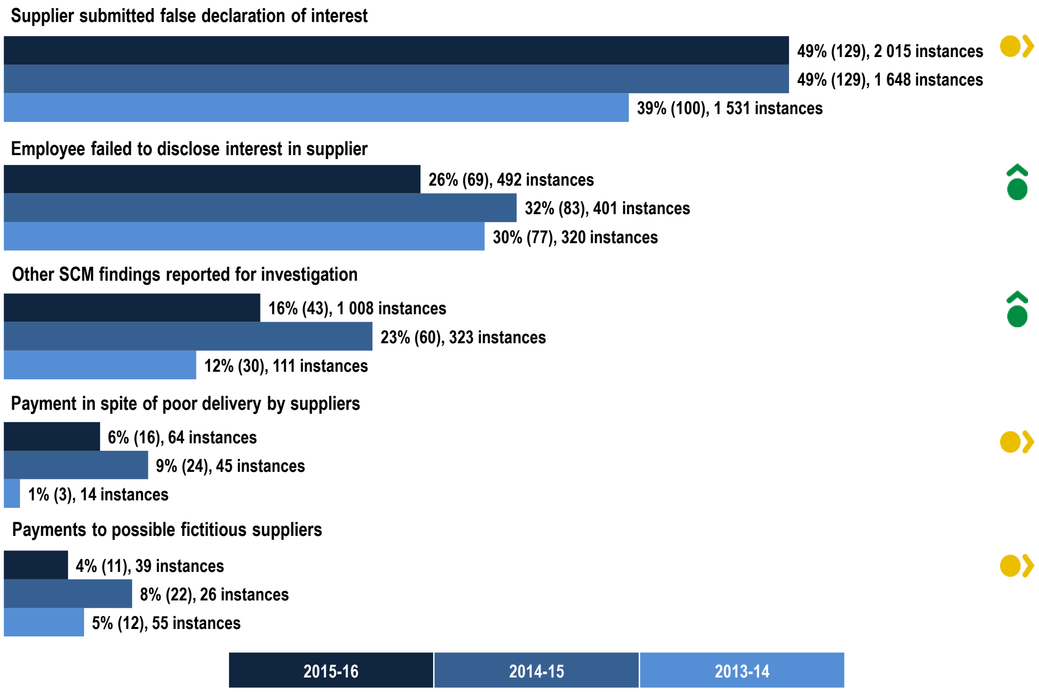
These findings were mostly in North West (18 municipalities), the Eastern Cape (13 municipalities), KwaZulu-Natal (12 municipalities) and Mpumalanga (12 municipalities).

Supply chain management findings reported for investigation

We report all our findings on SCM compliance and weaknesses to management for follow-up. If there are **indicators of possible fraud or improper conduct in the SCM processes**, we recommend that management conduct an investigation. The findings recommended for investigation are highlighted in the executive summary of our management reports to ensure that the municipal manager, mayor and audit committee take note thereof.

Figure 4 illustrates the extent of SCM findings we had reported to management for investigation.

Figure 4: Supply chain management findings reported to management for investigation



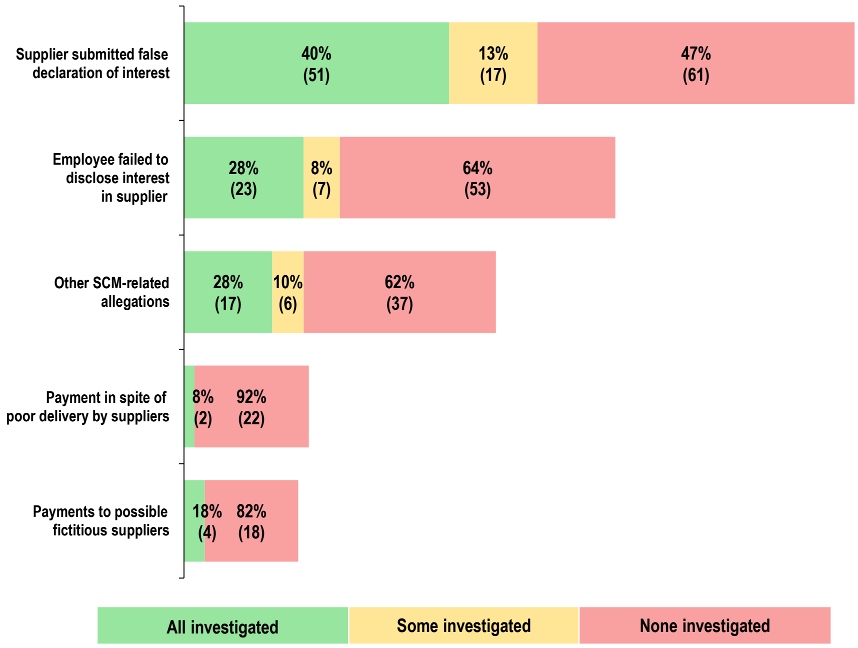
In 2015-16, we reported these types of findings at 161 municipalities (61%), which is a slight improvement from the 165 municipalities (63%) in 2014-15. In total, 74% of the 165 municipalities that had such findings in 2014-15 had similar findings in 2015-16.

As detailed in section 4.2.1, awards were made to **suppliers who submitted fraudulent declarations**. The submission of fraudulent declarations by suppliers at nearly half of the municipalities is concerning. This was most common in KwaZulu-Natal (34 municipalities), the Eastern Cape (22 municipalities), Mpumalanga (15 municipalities) and Limpopo (15 municipalities). The municipalities with the highest instances of the submission of fraudulent supplier declarations were eThekwini Metro (377 suppliers), City of Johannesburg Metro (80 suppliers), City of Cape Town Metro (68 suppliers) and Ekurhuleni Metro (59 suppliers).

There had been little improvement in the type of findings reported since the previous year, except with regard to employee declarations and other SCM findings reported for investigation. This was as a result of municipal management not investigating our findings and ensuring that there were consequences for non-compliance and transgressions.

Figure 5 shows whether all, some or none of the previous year's SCM findings reported for investigation had been investigated.

Figure 5: Follow-up of the previous year's supply chain management findings

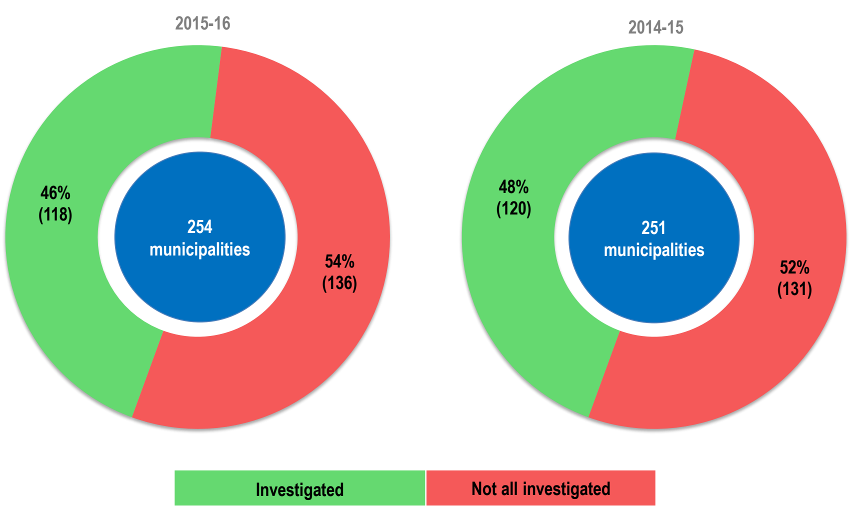


Although 56 of the 165 municipalities (34%) investigated all of the SCM findings reported for investigation in the previous year, the fact that 82 municipalities (50%) had not done so is concerning. The provinces with the highest number of municipalities where none of the SCM findings reported for investigation in the previous year had been investigated were the Eastern Cape (21), North West (17) and KwaZulu-Natal (12).

Investigation and follow-up of unauthorised, irregular and fruitless and wasteful expenditure

Figure 6 shows the overall status of investigations at the municipalities that had incurred unauthorised, irregular and fruitless and wasteful expenditure in the previous year.

Figure 6: Investigation of unauthorised, irregular and fruitless and wasteful expenditure



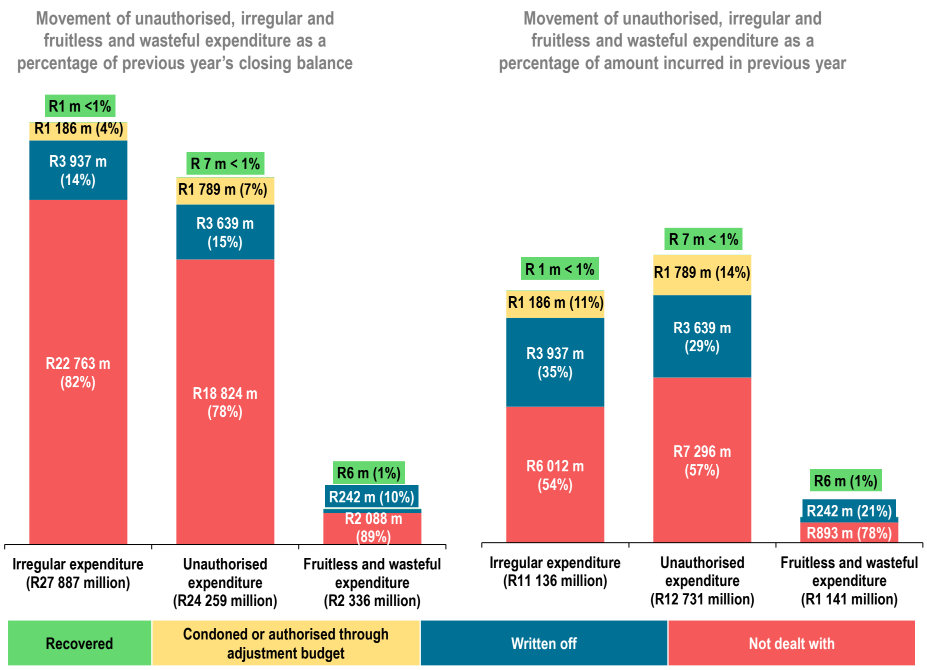
At over 50% of the municipalities, the **council failed to conduct the required investigations into all instances** of unauthorised, irregular and fruitless and wasteful expenditure reported in the previous year, which is a slight regression from the previous year. A total of 112 of the 131 municipalities (85%) that did not conduct investigations in 2014-15 again did not do so in 2015-16.

Of particular concern is that sufficient **steps were not taken to recover, write-off, approve or condone** unauthorised, irregular and fruitless and wasteful expenditure as required by legislation. As explained in section 4.2.1, irregular expenditure must be investigated to determine who is responsible and what the impact of the non-compliance was. Based on the outcome of the investigation, the next steps are determined and can include condonement or recovery of the expenditure. A similar process should be followed for unauthorised and fruitless and wasteful expenditure.

As a result, the year-end balance of irregular expenditure that had accumulated over many years and had not been dealt with totalled R41,7 billion, while that of unauthorised expenditure was R34,3 billion and that of fruitless and wasteful expenditure was R2 990 million.

Figure 7 shows that only a small portion of unauthorised, irregular and fruitless and wasteful expenditure of the previous years and the current year had been properly dealt with in the current year.

Figure 7: Movement in unauthorised, irregular and fruitless and wasteful expenditure balances



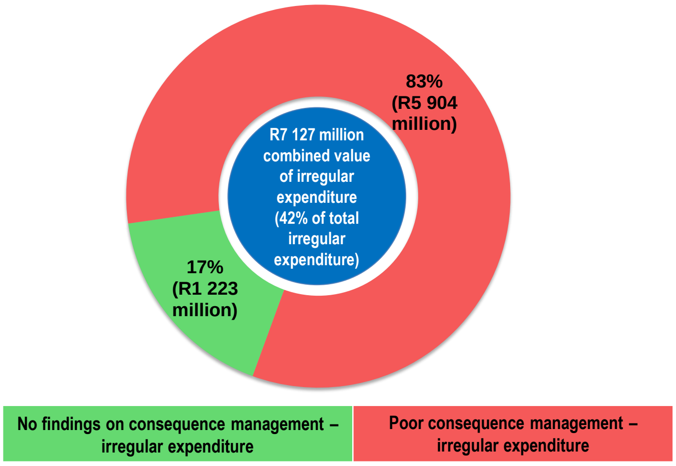
Over 50% of the unauthorised, irregular and fruitless and wasteful expenditure incurred in the previous year had not been properly dealt with.

The fact that municipalities cannot condone their own irregular expenditure played a role in the accumulation of this expenditure. Municipalities have to request condonement from the 'owners' of the legislation that had been transgressed, mostly the National Treasury. This typically requires additional information and takes some time to be considered. Some of the expenditure had also been incurred a number of years ago and the persons responsible were no longer in the service of the municipality or information was no longer available. In these cases, the municipalities should seek guidance from the National Treasury on how to deal with the expenditure.

Highest contributors to irregular expenditure linked to poor consequence management

Figure 8 highlights the correlation between poor consequence management practices and the highest contributors to irregular expenditure, as detailed in section 4.2.1.

Figure 8: Correlation between poor consequence management practices and the highest contributors to irregular expenditure



Eight of the 10 highest contributors to irregular expenditure had poor consequence management practices relating to irregular expenditure as well as to at least fruitless and wasteful expenditure or unauthorised expenditure.

As long as the political leadership and municipal officials do not make accountability for transgressions a priority, irregular expenditure, unauthorised expenditure and fruitless and wasteful expenditure as well as fraud and misconduct will continue to be widespread in local government. The majority of the municipalities have the required policies and processes to ensure that transgressions and fraud are identified and acted upon, but chose not to use it – a clear indicator of a lack of commitment to accountability.

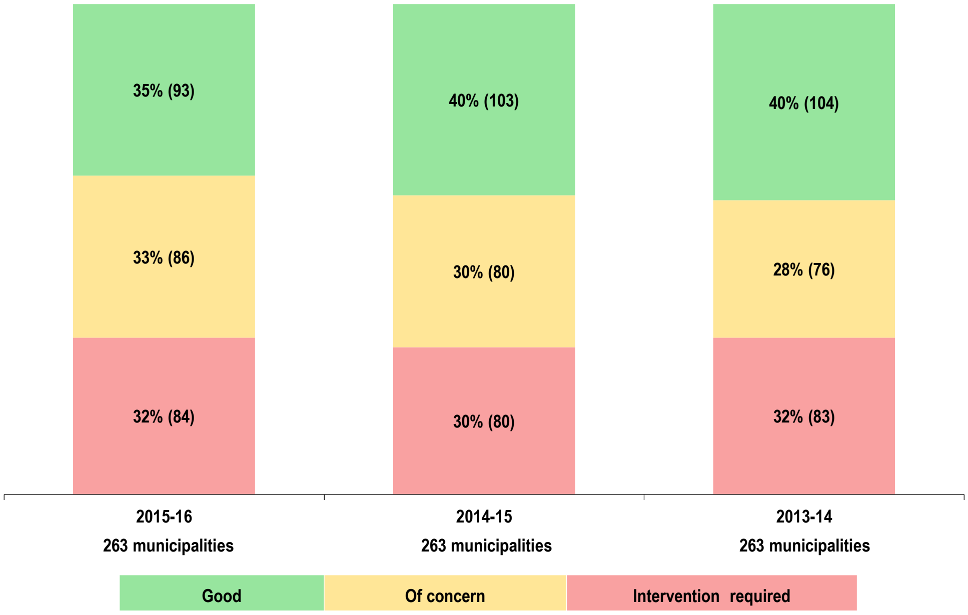
4.3 Financial health

Our audits included a high-level analysis of 10 financial indicators to provide management with an overview of selected aspects of their current financial management and to enable timely remedial action where the municipality's operations and service delivery may be at risk. We also performed audit procedures to assess whether there were any events or conditions that might cast significant doubt on a municipality's ability to continue its operations in the near future. Based on the analysis, each municipality was given an overall assessment as follows:

Good	Two or fewer unfavourable indicators
Of concern	More than two unfavourable indicators
Intervention required	Significant doubt that operations can continue in future and/or where municipalities received a disclaimed or adverse opinion, which meant that the financial statements were not reliable enough for analysis

Figure 1 shows our assessment of the **financial health of municipalities** over the past three years. The 2013-14 and 2014-15 figures have been restated to take into account changes in the indicators used to assess the financial health of municipalities.

Figure 1: Number of municipalities with indicators of financial health risks (overall)

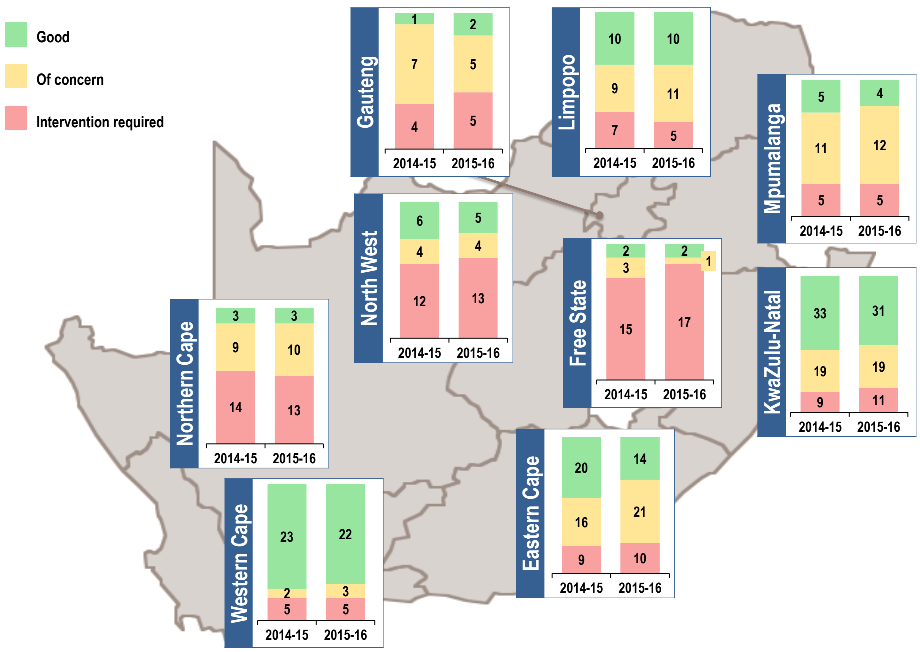


The number of municipalities we assessed as having a good financial health status had slightly decreased since 2014-15, with the municipalities in Gauteng, Limpopo and KwaZulu-Natal being the main contributors to the regression. The regression can be attributed to inadequate processes to ensure sound financial management and the poor economic conditions prevailing in the country over the past several years, which are characterised by high consumer debt and resultant debtor default.

The slight increase in the number of municipalities in the 'intervention required' category since 2014-15 was as a result of the increase in municipalities that had going concern uncertainties.

Figure 2 indicates the number of municipalities per province with indicators of financial health risks.

Figure 2: Provincial overview of municipalities with indicators of financial health risks

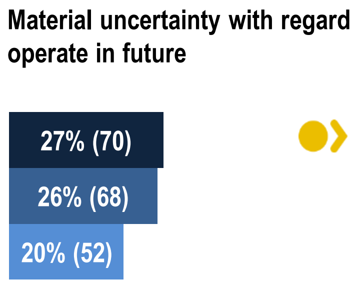


We provide further details below of the main financial indicators used for these assessments over the three-year period. The following legend applies to the figures shown:

2015-16	2014-15	2013-14

Figure 3 reflects the number of municipalities that in the past three years disclosed in their financial statements that a **material uncertainty** existed with regard to their ability to operate in the foreseeable future (in other words, as a going concern) or had received a financially qualified opinion because such disclosures were not included.

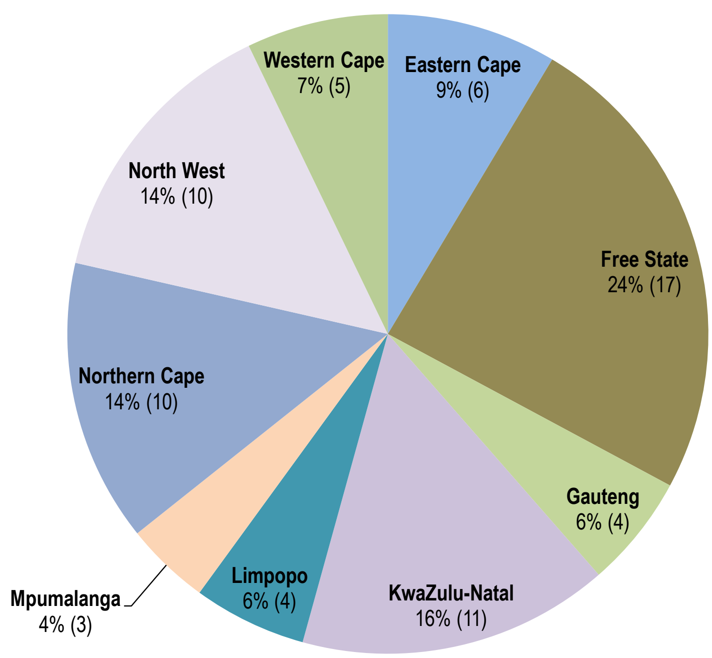
Figure 3: Going concern uncertainty



A **going concern uncertainty** existed at more than a quarter of the municipalities in 2015-16 – a slight increase from the previous year. Regressions were most notable in the Free State and Gauteng. Seventeen (85%) of the municipalities in the Free State had a going concern uncertainty. These municipalities faced significant cash-flow constraints, as they did not maximise the collection of outstanding amounts from consumers, which contributed to overdue payments to large creditors such as Eskom and water boards for their bulk purchases.

Figure 4 shows the provincial overview of the 70 municipalities where a going concern uncertainty existed.

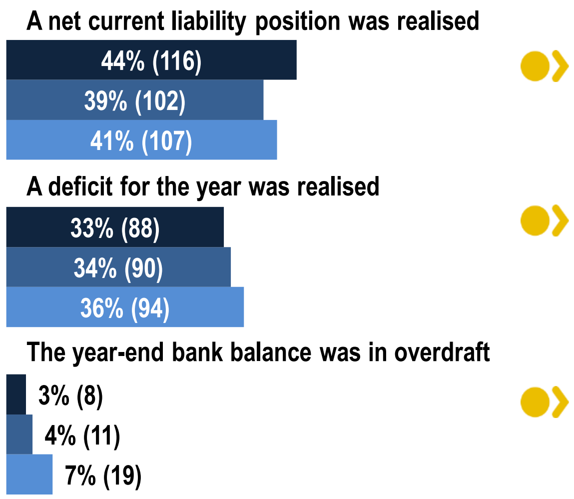
Figure 4: Provincial overview of going concern uncertainty



The regression overall was the result of poor debt collection, cash-flow constraints and a lack of effective and efficient revenue-generation and debt-collection strategies. Improvements from disclaimed opinions to unqualified or qualified opinions further made the financial statements more reliable for assessing going concern uncertainty, which also contributed to the movements.

Figure 5 shows some of the typical indicators of going concern uncertainty over the past three years, in addition to the revenue management and creditor-payment period indicators detailed later on in this section.

Figure 5: Sustainability indicators



There had been a slight improvement since 2014-15 in the number of municipalities that spent more than their available financial resources (resulting in a **net deficit**), while those whose current liabilities exceeded their current assets at year-end (**net current liability position**) showed a slight regression over the same period.

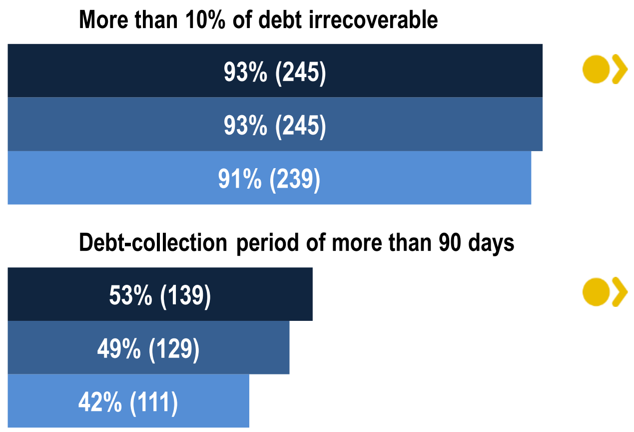
The municipalities in Limpopo and North West were the main contributors to the slight improvement relating to the net deficit. While some municipalities improved in North West, 50% of the municipalities in the province still incurred a deficit. The Free State had the highest number of municipalities with a deficit (70%).

Municipalities in Gauteng, KwaZulu-Natal and Mpumalanga were the main contributors to the slight regression with regard to the net current liability position, which was caused by cash-flow problems (mainly due to poor debt collection and the inability to pay creditors).

The number of municipalities with year-end **bank balances in overdraft** had decreased slightly since the previous year.

One of the main reasons for the failing financial health of municipalities is inadequate **revenue management**. The main indicators over the past three years in this regard are reflected in figure 6.

Figure 6: Revenue management

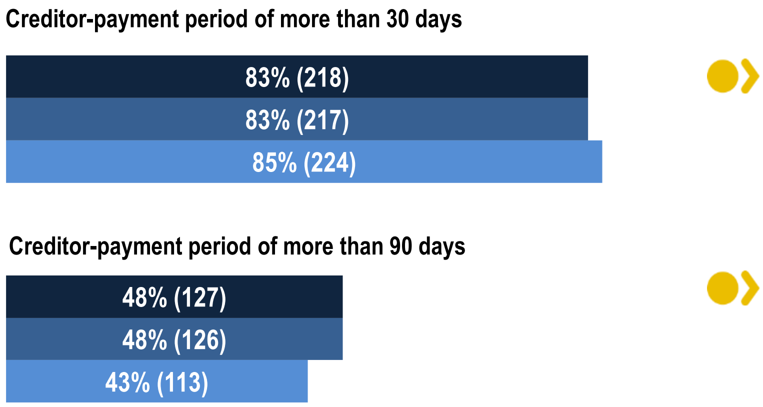


Just over 90% of municipalities estimated in their financial statements that more than 10% of the outstanding amounts owed to them would not be paid, which remained unchanged over the two-year period.

As part of our analysis, we calculated the average number of days it took municipalities to **collect debt** they deemed to be recoverable. Just over half of the municipalities had an average debt-collection period of over 90 days in 2015-16. This is a slight regression from the previous year. Municipalities in the Eastern Cape, the Free State, Gauteng, Limpopo and KwaZulu-Natal were the main contributors to the regression. The reasons for the poor revenue management were a lack of the right skills in finance units, the poor economic climate as well as inadequate systems to account for revenue, which not only affected debt collection but also the ability to account correctly for debtors in the financial statements.

Extended collection periods put the cash flow of municipalities under significant pressure, which in turn meant that they took longer to pay their creditors. Figure 7 shows the number of municipalities with an average **creditor-payment period** of more than 30 days and more than 90 days over the three-year period.

Figure 7: Creditor-payment period



The number of municipalities with extended payment periods over 30 and over 90 days showed no movement at 83% and 48%, respectively. While the movement remained stagnant, over 60% of the municipalities in the Free State, Mpumalanga, the Northern Cape and North West had average extended payment periods of over 120 days. Only three municipalities in the Western Cape had such long payment periods. Municipalities with extended creditor-payment periods are running the risk of key suppliers discontinuing their services, which may have a significant impact on service delivery.

Our analysis of financial health shows a continuing weakening in local government finances as a result of the poor collection of revenue from debtors, cash-flow problems and the current poor economic climate at a time when municipalities are under increasing pressure to provide basic services while financial resources are dwindling.

According to a report published in March 2017 by the National Treasury entitled *The state of local government finances and financial management as at 30 June 2016*, the inability of municipalities to generate own revenue has led to high reliance on the conditional grants from national and provincial government to fund capital programmes. Based on their analysis of 273 municipalities, conditional grants funded more than 75% of the capital budget of 125 municipalities (46%). At only 91 (33%), the funding was less than 30%. This further continued to place the fiscus under pressure.

4.4 Management of grants

Municipalities annually receive conditional grants from the national revenue fund as approved in terms of the Division of Revenue Act (DoRA). Municipalities may only use a conditional allocation for its stated purpose in accordance with the requirements of the framework for each grant and for projects or programmes included in their business plans.

Our audits included testing compliance with DoRA and the individual grant frameworks, evaluating how the funding was used, and assessing the management of the projects funded by the grants.

In this section, we present the results of these audit tests for the **MIG**, the **USDG** and the **PTNG**. We also look at overall **compliance by municipalities with DoRA**. More information on our audits as well as the purpose of, and conditions attached to, these grants is included in section 13.1.

Municipal infrastructure grant

The DCoG introduced the **MIG** in 2004-05 to improve poor communities' access to basic service infrastructure by providing specific capital finance for basic municipal infrastructure backlogs.

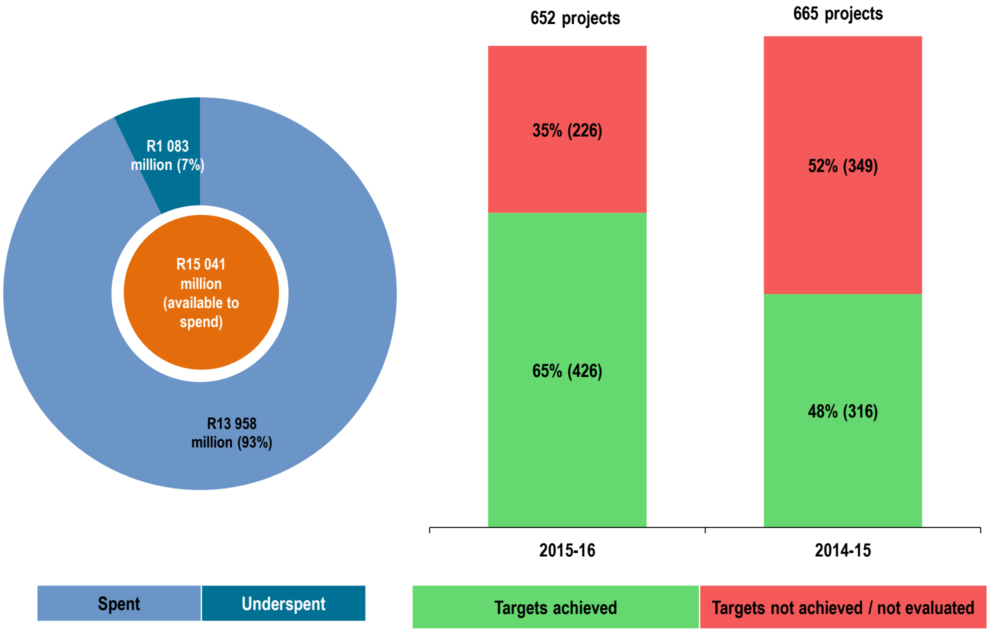
In 2015-16, R14,96 billion was allocated in terms of DoRA for the MIG to 247 municipalities. This section includes the analysis of only 234 municipalities for which audits had been completed by the cut-off date. The MIG allocated to these 234 municipalities amounted to R14,14 billion. Due to unspent funds rolled over from the previous financial year, the municipalities had R15,04 billion to spend on infrastructure projects funded from the MIG. Table 1 shows the MIG spending per province.

Table 1: Spending of municipal infrastructure grant per province

Province	Municipal infrastructure grant	
	Percentage spent	Amount R million
Eastern Cape	95%	3 063
Free State	90%	402
Gauteng	97%	446
KwaZulu-Natal	98%	3 413
Limpopo	85%	2 740
Mpumalanga	93%	1 817
Northern Cape	93%	365
North West	89%	1 224
Western Cape	97%	488
Total	93%	13 958

Figure 1 shows how much of the MIG allocations municipalities had spent and whether the planned targets for the infrastructure projects audited, had been achieved in 2015-16 and 2014-15. We audited 652 projects funded by the MIG in 2015-16. The projects in the red category are those where the targets were not achieved, the municipality had not assessed the achievement, or we could not audit the assessment as supporting documentation was not provided.

Figure 1: Municipal infrastructure grant: spending and achievement of planned targets



In 2015-16, 93% of the **available grant was spent** – an improvement from the 87% in 2014-15. In total, 105 municipalities underspent on the MIG, of which 53 underspent by more than 10%. This is an improvement from the 123 municipalities that had underspent in 2014-15.

At 94% of these municipalities, the grant money was **used for its intended purpose**. Where the grant money was not used for its intended purpose, it was reported in the audit report and/or management report as non-compliance with DoRA. Five of these municipalities (which did not spend the grant money for its intended purpose) were in the Free State and four in the Eastern Cape. Examples of this practice are Mafube and Masilonyana in the Free State that used the grants for operating expenditure.

We continued to audit the multi-year projects selected in 2014-15. We also selected other projects, mostly those that deliver water and sanitation infrastructure. Although there has been an overall improvement in the **achievement of the targets set for these projects** (as shown in figure 1), the slow delivery of projects affects the ability of municipalities to improve access to basic services for poor communities. A grant amount of R6 099 million was provided for 226 projects at 92 municipalities where the targets were not achieved or performance had not been evaluated, of which R5 511 million (90%) had been spent.

Table 2 shows our **key findings** from the audit of these projects – the table includes the number and percentage of municipalities and projects affected in each province.

Table 2: Findings on projects funded by the municipal infrastructure grant

Findings		Total	Eastern Cape	Free State	Gauteng	KwaZulu-Natal	Limpopo	Mpumalanga	Northern Cape	North West	Western Cape
Planned targets not achieved / Performance on project not evaluated	Projects	226 (35%)	42 (35%)	13 (33%)	1 (5%)	25 (15%)	45 (48%)	20 (41%)	33 (63%)	38 (63%)	9 (16%)
	Municipalities	92 (40%)	17 (43%)	6 (38%)	1 (14%)	12 (20%)	9 (35%)	11 (61%)	15 (71%)	17 (85%)	4 (17%)
Incorrect performance reporting	Projects	72 (11%)	17 (14%)	4 (10%)	1 (5%)	5 (3%)	5 (5%)	2 (4%)	14 (27%)	21 (35%)	3 (5%)
	Municipalities	35 (15%)	8 (20%)	2 (13%)	1 (14%)	4 (7%)	2 (8%)	2 (11%)	5 (24%)	10 (50%)	1 (4%)
SCM findings on project	Projects	192 (29%)	36 (30%)	14 (35%)	2 (10%)	16 (10%)	49 (52%)	21 (43%)	19 (37%)	31 (52%)	4 (7%)
	Municipalities	65 (28%)	12 (30%)	5 (31%)	2 (29%)	7 (12%)	7 (27%)	10 (56%)	8 (38%)	12 (60%)	2 (8%)
Misstatements identified	Projects	84 (13%)	22 (18%)	3 (8%)		6 (4%)	32 (34%)	3 (6%)	11 (21%)	7 (12%)	
	Municipalities	21 (9%)	6 (15%)	2 (13%)		2 (3%)	2 (8%)	2 (11%)	4 (19%)	3 (15%)	

The following are examples of weaknesses that we observed in the infrastructure projects funded by the MIG:

- Highmast phase 2 commenced in April 2016 in Tubatse (Limpopo) to improve the provision of basic services (lighting) in the rural areas of the municipality. The project was planned to be completed by 31 July 2016 with a target of 70 highmast lights. At year-end, only 40 highmast lights had been completed at a cost of R8,3 million financed through the MIG. Because the municipality appointed the contractor late, the targeted completion date was not met. The project is significantly behind schedule and many rural areas in the municipality remain without lighting.
- The Garies bulk water infrastructure project commenced during 2016 in Kamiesberg (Northern Cape) to eradicate the use of sceptic tanks and ventilated pit latrines within the small towns that surround Garies. The project was financed through a R14,1 million MIG and the first phase, originally planned to be completed in December 2015, was completed in May 2016. The project was split into three phases, but due to challenges experienced during the first phase, the planned completion date of the entire project could possibly be delayed. Inadequate project planning and budgeting by the municipality caused these delays as changes had to be made to the original plan: the municipality had planned to make use of the old infrastructure as part of the project by upgrading the current facilities, but the old reservoirs were located on private land and the owner wanted compensation that had not been budgeted for. The municipality then changed the specifications to include new reservoirs that would be located on municipal land.
- Irregular expenditure was incurred on the Hertzogville/Malebogo project (in Tokologo in the Free State) for the upgrading of the community stadium. Competitive bidding was not followed at all and a supplier was merely appointed with no letter of deviation.

Urban settlement development grant and public transport network grant

The **USDG** was introduced to assist metropolitan municipalities in improving access to basic services to households through the provision of bulk and reticulation infrastructure as well as urban land production to support broader urban development and integration. The **PTNG** aims at providing accelerated construction and improvement of non-motorised transport infrastructure.

In 2015-16, R10,55 billion to eight metros and R5,95 billion to 13 municipalities were allocated in terms of DoRA for the USDG and the PTNG, respectively.

The USDG allocated to seven metros (excluding Mangaung Metro for which the audit had not been completed by the cut-off date) amounted to R9,86 billion. Due to unspent funds rolled over from the previous financial year, the municipalities had R10,55 billion to spend on projects funded by the USDG.

The PTNG allocated to 11 municipalities (excluding Mangaung Metro and Rustenburg for which the audits had not been completed by the cut-off date) amounted to R5,37 billion. Although a DoRA allocation was made to Buffalo City Metro, the metro did not receive the allocation of R22 million, as the municipality did not have the capacity to implement the grant requirements. This, combined with the unspent funds rolled over from the previous financial year, meant that the municipalities had R5,36 billion to spend on projects funded by the PTNG in 2015-16.

Figures 2 and 3 show how much of the USDG and the PTNG municipalities had spent and whether the planned targets for the projects tested had been achieved.

Figure 2: Urban settlement development grant: spending and achievement of planned targets

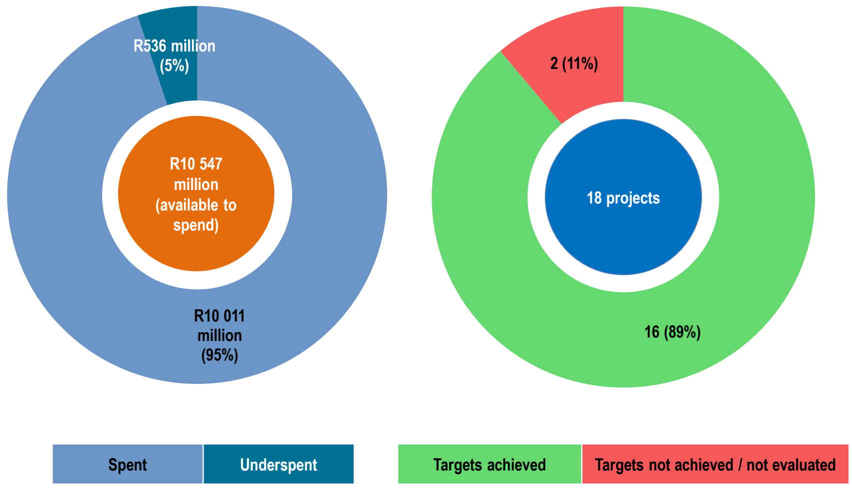
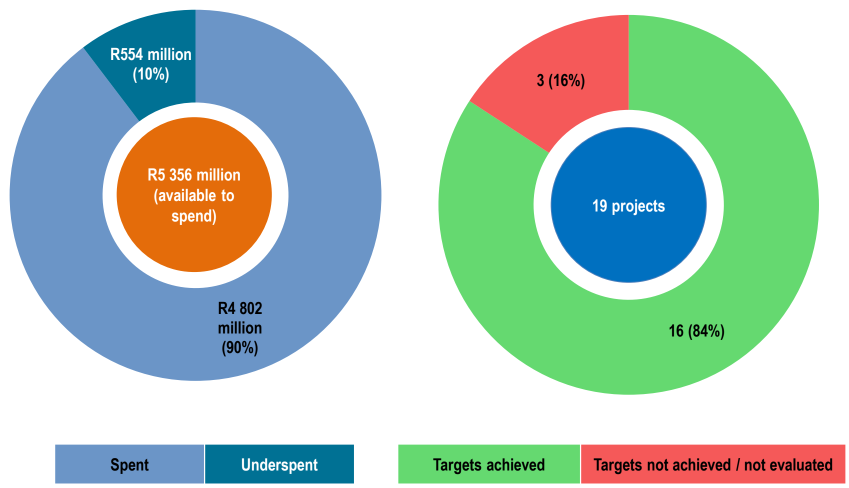


Figure 3: Public transport network grant: spending and achievement of planned targets



The **targets for the majority of the projects** had been achieved, goods and services were received for the money spent, and performance was evaluated on projects funded by the USDG and the PTNG. Ekurhuleni Metro was the only municipality that **underspent** the USDG by more than 10%, mainly due to delays in finalising designs, cash-flow problems by service providers, and disputes with constructors and service providers. The City of Cape Town Metro, Mbombela, Msunduzi and Nelson Mandela Bay Metro underspent the PTNG by more than 10%, mainly due to delays in procurement processes and designs, which resulted in work on some projects starting late. Ekurhuleni Metro alone was responsible for R291 million (54%) of the total underspending of R536 million relating to the USDG.

Targets were not achieved or evaluated at Ekurhuleni Metro and the City of Tshwane Metro on two projects that were funded by the USDG and three projects that were funded by the PTNG. We also raised SCM findings on one project funded by the USDG at the City of Johannesburg Metro.

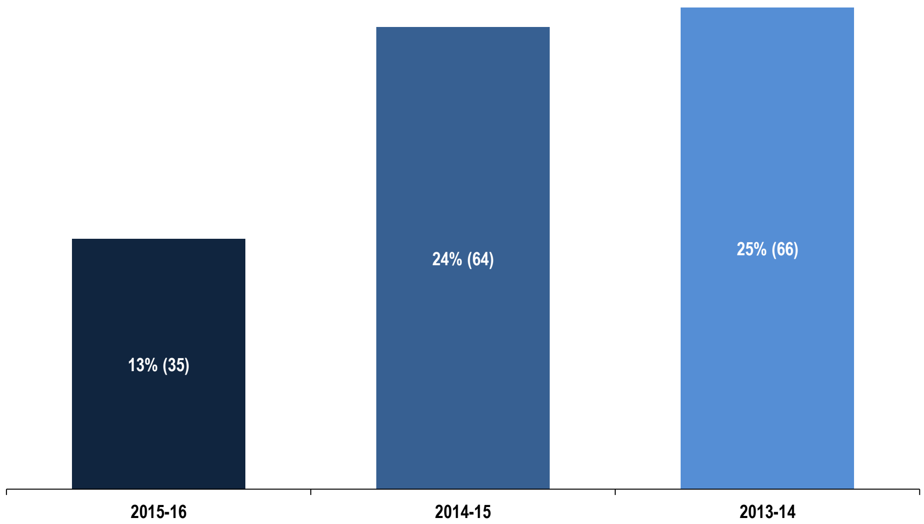
The following are examples of weaknesses that we observed in the infrastructure projects funded by the USDG and the PTNG:

- Targets were not achieved on the project funded by the USDG to upgrade gravel to tar in the Ekangala ward in the City of Tshwane Metro, due to the late appointment of a panel of consultants. The BRT line 2C project funded by the PTNG was deferred to 2016-17 due to a policy decision on lane acquisition, which could result in the revision of the designs.
- At an overall level, a large number of variation orders were issued on projects funded by the PTNG. In addition, a number of accidents and incidents occurred at the integrated rapid public transport network locations, some of which related to construction, pointing to safety risks. Some quality issues were also identified during site visits, such as the deterioration of bus lanes due to a lack of maintenance.

Non-compliance with the Division of Revenue Act

Figure 4 shows the number of municipalities that received a conditional grant via a DoRA allocation where we **reported material findings on compliance** with the act.

Figure 4: Non-compliance with the Division of Revenue Act in managing conditional grants



As indicated in figure 4, only 13% of the municipalities failed materially to comply with DoRA – an improvement from the 24% in the previous year. The most notable improvements were in North West (26%), Mpumalanga (19%) and the Eastern Cape (16%) due to improved controls at the municipalities as well as oversight by some external stakeholders.

The common compliance findings below indicate that not all municipalities properly managed the funds provided through grants and the funded programmes:

- The performance of the programmes funded by allocations was not evaluated – 27 municipalities (2014-15: 45).
- Allocations were used for purposes other than those stipulated in DoRA or in the gazetted framework – 13 municipalities (2014-15: 25).

Conditional grants are allocated to drive specific government objectives. It is important that projects and programmes funded by grants are closely managed to ensure that they not only meet the set targets, but also deliver the intended outcomes.

4.5 mSCOA readiness of municipalities – an emerging risk

The **mSCOA** project is part of the National Treasury's ongoing budget and reporting reforms aimed at improving financial reporting. With effect from 1 July 2017, all municipalities will have to capture all their financial transactions against a predefined classification framework, which will result in uniformity of line items in terms of revenue, expenditure, assets and liabilities. This will thus have an impact on the 2017-18 financial statements and audits of all local government auditees. Piloting takes place in close cooperation with the National Treasury's mSCOA project team and provincial treasuries.

The objectives of the project are as follows:

- Enable the alignment of budget information captured in the course of the implementation of the budget.
- Improve data quality and credibility.
- Achieve a greater level of standardisation.
- Develop uniform data sets critical for 'whole-of-government' reporting.
- Standardise and align the local government accountability cycle by the regulation of not only the budget and in-year reporting formats but also the annual report and annual financial statement formats.
- Create the opportunity to standardise key business processes with the consequential introduction of further consistency in the management of municipal finances.
- Improve transparency, accountability and governance through the uniform recording of transactions at posting account level detail.
- Enable deeper data analysis and sector comparisons to improve financial performance.
- Standardise the account classification to facilitate mobility in financial skills within local government and between local government and other spheres as well as the private sector and to enhance the ability of local government to attract and retain skilled personnel.

Figure 1 indicates our overall assessment of the state of readiness of municipalities to implement mSCOA, while figure 2 shows a provincial overview of mSCOA readiness.

Figure 1: Readiness for mSCOA

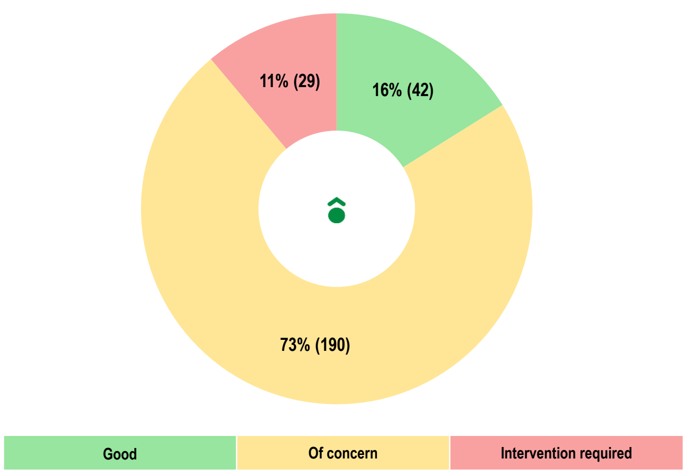
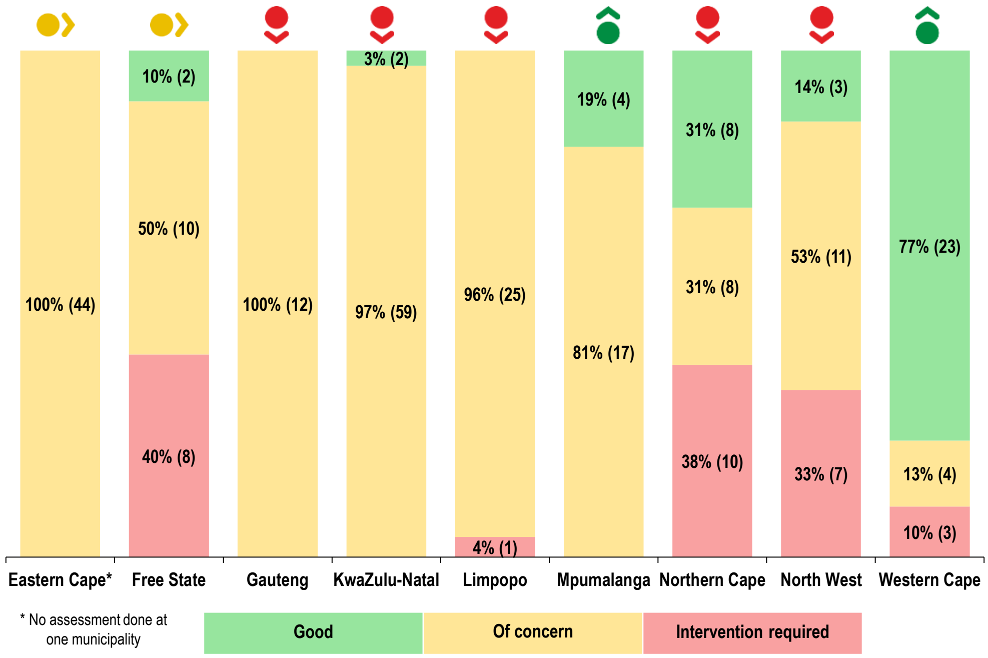


Figure 2: Provincial overview of mSCOA readiness



Municipalities generally made slow progress in ensuring that they would be ready to implement mSCOA by the due date. As indicated in figure 1, the readiness of 73% of the municipalities was still concerning, while that of 11% still required intervention, which represent the majority of municipalities. Regressions were noted in Gauteng, KwaZulu-Natal, Limpopo, North West and the Northern Cape due to some municipalities, which were previously on track with their mSCOA implementation, falling behind in 2015-16. Furthermore, Mpumalanga and the Western Cape showed a significant improvement in ensuring readiness to implement mSCOA by 1 July 2017. The Free State, the Northern Cape and North West were among the provinces that required intervention at more than a third of their municipalities, as they did not pay attention to the previous year's assessment results – which could mean that they will not be able to meet the implementation date.

Some of the **root causes** that may result in municipalities **not meeting the implementation due date** are the following:

- Municipalities experienced capacity and skills constraints that made it difficult to plan and manage the change to mSCOA requirements.
- Municipalities did not have the money to commence with the implementation of mSCOA and to use the internal audit unit to support them from a project-assurance perspective.
- Municipalities were waiting for the outcomes of the pilot municipalities that were implementing mSCOA to ensure that they address the lessons learned from these pilots.
- Municipalities experienced challenges with regard to data-cleansing, data-migration and data-mapping processes within the current systems.
- Municipalities had to keep up to date with the different versions of mSCOA that were released, which created some uncertainty. However, the National Treasury indicated in MFMA Circular No. 80 that mSCOA version 6 would be released and locked down for the 2017-18 financial year for transacting and auditing.

The following **actions** should be taken **to address the root causes**:

- All municipalities should follow the guidance provided by the National Treasury and issued through MFMA SCOA circulars.
- Ongoing training is of the utmost importance to capacitate staff in the successful implementation of mSCOA. The National Treasury, in partnership with the Institute of Municipal Finance Officers (IMFO), developed accredited training to provide an introduction and theoretical information on mSCOA, including testing of candidates. Municipalities should liaise with their provincial treasury to arrange for non-accredited training, geared at converting their existing trial balance to the mSCOA chart.
- Municipalities should share their experiences and lessons learned with the implementation of mSCOA to ensure that efficiencies are built into the process.
- Municipalities should continue to prepare for the implementation of mSCOA or keep the momentum going if they are already busy with implementation to ensure that all implementation challenges are resolved by 1 July 2017.

Conclusion

Sustainable improvements in financial management can be achieved if the leadership clearly defines the targets to be achieved in terms of audit outcomes, project delivery and financial health by using, among other, audit action plans, the new integrated development plan, service delivery and budget implementation plan, annual budget and project plans (**PLAN**).

The basic disciplines of proper record keeping and standard daily and monthly controls built on a foundation of effective and efficient leadership and stability in key positions will enable a robust financial management system (**DO**).

Regular, credible in-year reporting monitored by, and acted upon, senior management, the municipal manager, the mayor as well as reports and recommendations on financial management and compliance from the internal audit unit and the audit committee will enable corrective action to be taken if targets are not achieved or if transgressions or poor performance is identified (**CHECK**).

Consistently investigating indicators or allegations of transgressions and poor performance and applying consequence management will ensure that a culture of accountability prevails (**ACT**).