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Auditor-general reports marginal improvements in local government audit results

PRETORIA – The auditor-general (AG), Kimi Makwetu, today reported limited improvements in the audit results of South Africa's municipalities for the past financial year.

Releasing his 2015-16 local government audit outcomes report, Makwetu said overall the local government had failed to maintain the promising five-year momentum – gained in the years 2010-11 to 2014-15 – that he reported on last year.

AG's report calls for leadership accountability

In his latest report, Makwetu highlights the importance of accountability in the management of municipal affairs, starting with appropriate planning focused on the needs of citizens, instituting appropriate internal control and supervision that will ensure proper financial and performance management. He also mentions respect for the law in the running of municipalities, monitoring by all political and administrative leadership that budget and performance targets are appropriately achieved, and that there are consequences for mismanagement and non-performance.

Makwetu says if these basic principles of accountability, built around a central theme of strong internal control and good governance, are in place, municipalities should be well geared to live up to the expectations of the communities that they serve.

The AG also noted that the limited improvement in audit outcomes over the past year shows that accountability for these important functions was not as strong as it should be.

The importance of strong internal controls

Strong internal controls are the key to ensuring that municipalities deliver on their priorities in an effective, efficient and economical manner. This also ensures that they produce quality financial statements and performance reports, and comply with applicable legislation – especially in the areas of procurement and contract management. In the year under review there was little, if any improvement in the overall strength of internal controls in the municipal sphere of government.

Makwetu highlighted the following basic controls that still require attention:

- Leadership creating a culture of honesty, ethical business practices and good governance.
- Proper record-keeping to ensure that complete, relevant and accurate information is accessible and available to support financial and performance reports.
- Instilling basic controls to ensure the processing of transactions in an accurate, complete and timely manner.
- Monitoring of compliance with legislation (i.e. rules and regulations).
- Filling of vacancies in critical areas such as municipal managers, chief financial officers, heads of supply chain management and chief information officers, and generally ensuring an appropriate level of financial management capacity in a municipality.
- Instilling appropriate information technology controls, with emphasis on security management, user access management and business continuity.

- Following through on audit action plans.

The AG's report singles out the following recurring root causes as some of the major contributors to the minimal improvement in internal controls:

- The slow response by the leadership in improving key internal controls and addressing risk areas.
- Instability or vacancies in key positions or key officials lacking appropriate competencies.
- Inadequate consequences for poor performance and transgressions.

As a result of these root causes not being addressed, there was limited improvement in the audit outcomes of municipalities with 15% improving, 13% regressing and 67% remaining unchanged.

The audit outcomes at a glance

In its annual audits, the AGSA examines the following aspects:

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

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

The audit outcomes of **263** municipalities and a summary of the key audit outcomes of 51 municipal entities are included in the latest general report.

Movement in audit outcomes from 2014-15 to 2015-16

Movement → / Audit outcome ↓	42 Improved	185 Unchanged	36 Regressed	15 Outstanding audits
Unqualified with no findings = 49	2 (DM), 7 (LM)	1 (MET) 12 (DM) 27 (LM)		
Unqualified with findings = 122	3 (DM), 16 (LM) 2 (LM)	2 (MET) 11 (DM) 75 (LM)	2 (MET) 4 (DM) 7 (LM)	1 (MET) 2 (LM)
Qualified with findings = 63	1 (LM) 8 (LM)	2 (MET) 4 (DM) 38 (LM)	1 (LM) 3 (DM), 6 (LM)	3 (LM)
Adverse with findings = 4	2 (DM), 1 (LM)		1 (LM)	
Disclaimed with findings = 25		2 (DM) 11 (LM)	1 (LM) 10 (LM) 1 (DM)	9 (LM)

MET – metropolitan municipality DM – district municipality LM – local municipality
Colour of number indicates audit opinion from which municipality has moved

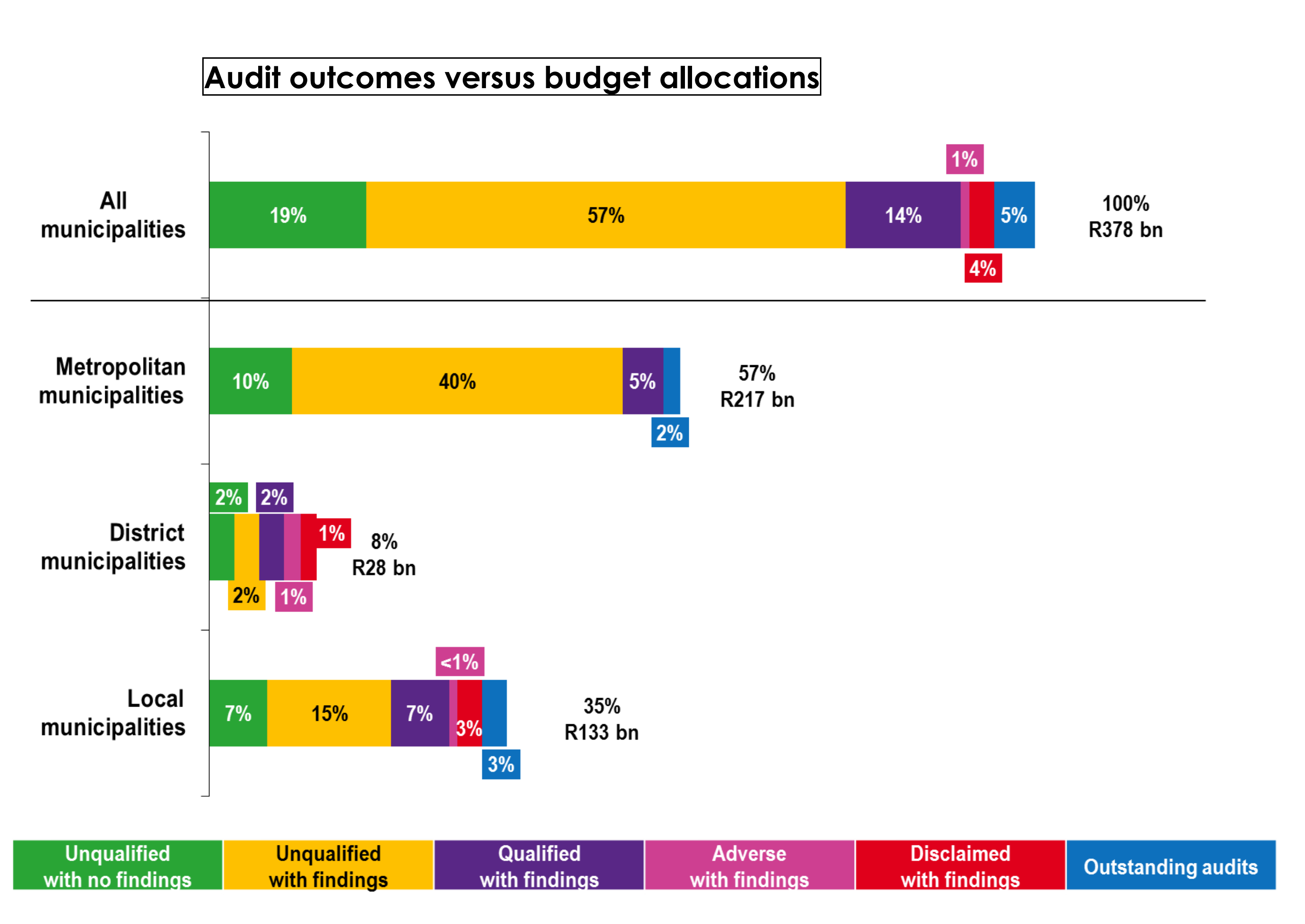
In total, 82% (40) of the municipalities with clean audit opinions in the previous financial year (2014-15) obtained this outcome again in the year under review (2015-16). The AG views this as 'an encouraging sign that improvements at these municipalities are sustainable'.

Unfortunately, 14 municipalities lost their clean audit status, while only nine moved into this category resulting in an overall decrease in municipalities with clean audit opinions. Metros and district municipalities should be leading by example in the local government sphere, yet only one metro (City of Cape Town) and 14 district municipalities (32% of the all district municipalities) received clean audit opinions.

Total local government expenditure budget in 2015-16

The expenditure budget for the municipal sphere in 2015-16 was R378 billion. Municipalities with clean audit opinions represent R70,9 billion (19%) of this amount, while those with unqualified opinions with findings represent R218 billion (57%).

Municipalities with qualified audit opinions made up R53,4 billion (14%) of the total budget, while those with adverse and disclaimed opinions represented R15,2 billion (5%). The municipalities with outstanding audits constitute R20,5 billion (5%) of the total expenditure budget.



Provinces with the highest proportion of clean audit opinions

The AG's report shows that the provinces with the highest proportion of municipalities with clean audit opinions in 2015-16 were the Western Cape (80%), KwaZulu-Natal (18%) and the Eastern Cape (16%).

The Western Cape continued setting the pace by increasing their clean audit opinions from 73% to 80% of their municipalities. The AG notes that the province's 'focused interventions and support by the provincial leadership through the premier's coordinating forum, operation clean audit and the municipal governance review and outlook processes continued to bear fruit'.

Despite having a relatively high number of clean audits compared to most other provinces, the audit outcomes of KwaZulu-Natal showed a significant regression this year. Makwetu cites, amongst others, 'instability and vacancies in key positions, coupled with the lack of accountability, internal control failures relating to compliance with key legislation that were not adequately monitored as well as leadership's slow response to recommendations made by internal audits and audit committees' as having contributed to the regression at 14 municipalities.

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

Makwetu said the audit outcomes of municipalities in the Eastern Cape, Limpopo and Mpumalanga showed momentum in the right direction, with the Eastern Cape showing the greatest improvement.

'The improvements in the Eastern Cape can be attributed to improved record keeping, the support provided by the provincial treasury and the provincial department of cooperative governance, the leadership attending to audit recommendations, the implementation of the minimum competency levels and the use of consultants,' says Makwetu.

He also points out that the improvements in Limpopo were as a result of increased focus to resolve audit findings in response to a strong stance taken by the premier that steps will be taken against municipal managers if audit outcomes are poor. Likewise, in Mpumalanga Makwetu says strong leadership, accountability and good human resource management at an increased number of municipalities had the desired effect.

'We commend the leadership in these provinces for decisively acting on and implementing our previous years' audit recommendations. We urge them to maintain this promising momentum,' says Makwetu.

Provinces that have lost their clean audit status of the previous year

The AG's report indicates that although Gauteng continued to perform well and was the only province where 100% of its municipalities received unqualified audit opinions on their financial statements, only the Midvaal municipality could hold on to its clean audit status. The report further reveals that not paying sufficient attention to supply chain management (SCM) and performance reporting led to three municipalities losing their clean audit status of the previous year.

Provinces that need to strengthen their governance systems

The AG named North West, the Northern Cape and the Free State as the provinces with the poorest audit results, based on the number of municipalities with disclaimed and adverse opinions or outstanding audits.

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

Significant audit observations

Financial health of municipalities

One of the more prominent implications of a weak system of internal control can be seen in its impact on the financial health of municipalities. In 2015-16 the AGSA rated the financial health of 65% of the municipalities as either concerning or requiring intervention, compared to the 60% in 2014-15.

The most concerning indicators over the past two years were municipalities spending more than the resources they had available (thus incurring a net deficit), current liabilities exceeding current assets at year-end (net current liability position), debtors not paying or taking very long to pay their debt, and creditors not being paid on time.

‘In total, 27% of municipalities were in a particularly poor financial position by the end of 2015-16, with material uncertainty with regard to their ability to continue operating in the foreseeable future,’ said Makwetu.

Slight improvement on the financial statements audit opinions

The report indicates that audit opinions on the financial statements only slightly improved from 60% to 62% unqualified opinions, while disclaimed and adverse opinions decreased from 13% to 10%. This, the report further notes, shows that the revised government’s Medium-term Strategic Framework targets of 65% unqualified opinions, 20% qualified audit opinions and a maximum of 15% disclaimed or adverse opinions by 2018-19 can therefore be achieved.

However, the AG was quick to point out that the poor quality of the financial statements submitted for auditing resulted in increased audit time and cost. He said that in 2015-16 only 31% (and not 62%) of municipalities ‘would have received an unqualified audit opinion had we, as auditors, not identified the misstatements and allowed the auditees to make corrections’.

Makwetu further cautioned that consultants should be used in an effective manner. ‘We found that at 130 municipalities (57%), the financial statements submitted for auditing included material misstatements in the areas in which consultants did work, which meant the misstatements were identified and corrected by the audit process and not by the consultant. This remains a concern regarding the effective use of these consultants.’ This comes against the background that consultancy fees for financial reporting services continued to increase to a cost of R838 million.

‘The poor quality of financial statements submitted to us for auditing and the continued reliance on consultants for financial reporting services call into question whether municipalities have the appropriate basic systems of internal control in place to ensure accurate and relevant in-year reporting,’ says the AG.

Improved quality of annual performance reports

The AG's report shows that the area in which the greatest improvement was recorded was the quality of performance reports. The number of municipalities with no material findings in this regard increased from 38% to 47%.

'The increased quality of this important service delivery accountability mechanism is encouraging, but a lot of improvement is still needed. The usefulness of the information in these reports significantly improved (with the number of municipalities with findings decreasing from 45% to 38%), but almost half of the municipalities still struggled to report reliable information on service delivery,' said the AG.

Compliance with relevant key legislation

There was a slight regression in the compliance with key legislation that governs municipal operations, with the number of municipalities with no material findings decreasing from 20% to 18%. The lapse in oversight and controls in the area of compliance was evident in a number of areas, including SCM, leading to increased irregular expenditure.

Supply chain management

SCM deficiencies at municipalities were noted particularly in the areas of competitive bidding (at 46% of municipalities) and obtaining three quotations (56%). The management of contracts also regressed (44%) and there had been no improvement in addressing the concerns we raised year on year about contracts being awarded to employees, councillors, their families and other state officials as well as documents going missing when the auditors want to audit a procurement process.

The AG says municipalities were also slow in preparing for the implementation of the SCM reforms introduced by the National Treasury, which include a central supplier database and the eTender portal – although these reforms should have been implemented from 1 July 2016, 63% of municipalities either had not started using the database/portal or had not updated their SCM policies by then.

Irregular expenditure

Irregular expenditure has increased by just over 50% since the previous year to R16,81 billion – the highest since we started tracking the values. Makwetu says the amount could be even higher, as a third of the municipalities disclosed that the full amount was not known and 24% were qualified as the amount they disclosed was incomplete. The top 10 contributors to irregular expenditure were responsible for 42% of the irregular expenditure.

However, Makwetu emphasises that 'irregular expenditure does not necessarily represent wastage or mean that fraud has been committed. This needs to be confirmed through investigations to be done by the council, but losses could already have arisen or may still arise if follow-up investigations are not undertaken.'

He further points out that 'the track record of local government in dealing with irregular expenditure and ensuring that there is accountability, is poor. The year-end balance of irregular expenditure that had accumulated over many years and had not been dealt with (through recovery, condonement or writing off) was R41,7 billion.'

Fruitless and wasteful expenditure

Fruitless and wasteful expenditure was 21 % lower in 2015-16 than in the previous year at R901 million. Despite this notable decrease, a number of municipalities still incurred this form of expenditure during the period under review. The amount of fruitless and wasteful expenditure incurred by municipalities in the Eastern Cape, Limpopo and North West had decreased from the previous year.

The general nature of the fruitless and wasteful expenditure related to interest and penalties on overdue accounts and late payments (at R814 million), litigation and claims (R23 million) and other matters (e.g. cancellation fees for accommodation and unsuccessful implementation of software) (R64 million).

Unauthorised expenditure

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

Consequences for persistent financial – and performance management as well as governance failures

'Accountability means that those performing actions or making decisions are answerable for them, but also that there should be consequences for transgressions, lack of action and poor performance,' Makwetu says. 'Municipalities should implement consequence management for officials who fail to comply with the applicable legislation, while appropriate and timely action must be taken against transgressors.'

The AG says 'without entrenched consequence management systems, the local government audit results we have just released are unlikely to shift or change towards the desired state. We believe the introduction of requisite consequences will go a long way in turning the tide towards wholesale good governance in the public sector'.

Makwetu's report comes at a time when the parliamentary committee responsible for his office – the multi-party Standing Committee on the Auditor-General (Scoag) – has started a debate on whether the Auditor-General of South Africa (AGSA) should be granted more powers.

Conclusion

According to the AG, the Constitution (section 152) asks that local government should provide a democratic and an accountable government for local communities. 'We believe that the newly elected mayors and councillors and the administration that supports them are ready to accept their responsibilities and are willing to be held accountable for the performance of the municipalities they now govern,' he says.

He also mentions that leading up to the finalisation and release of his latest report, his office met with the leadership in all provinces. These sessions, he said, were convened by the premiers with members of the executive committee, mayors, municipal managers and councillors. During these sessions there was consensus that an ongoing focus on improving internal controls is critical to strengthen financial and performance management in government.

There was agreement to continuously engage on the robustness of these controls and the related status of accounting records throughout the year. The need for consequence management and accountability, he noted, featured as a prominent element of these engagements and attending to these, will help to restore trust in the ability of municipalities to look after their finances more effectively. This will also enable municipal leadership to progressively meet their service commitments to citizens. 'We were encouraged by the tone and undertaking to act on our recommendations and observations,' says the AG.

'My office remains committed to working tirelessly within our mandate to strengthen financial and performance management in local government in South Africa, emphasising the need to do the basics right. We wish the new political leadership and administration well for the new term and encourage all stakeholders involved in local government to intensify their efforts to ensure that communities experience an improvement in the way their municipalities operate,' concluded Makwetu.

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Media note: The *Consolidated general report on the MFMA local audit outcomes* is available on www.agsa.co.za.

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