Financial health and unauthorised expenditure
5. Financial health and unauthorised expenditure

The accountability for government spending includes taking accountability for the financial health of auditees. The current economic climate increases the pressure on auditees to make sound financial decisions and contain costs. The need for service delivery continues to increase but budgets are being cut and other revenue streams are under strain. This section provides our view of financial health based on an analysis of the financial statements and the unauthorised expenditure incurred by departments.

Our audits included a high-level analysis of 10 financial health indicators for departments and nine financial health indicators for public entities to provide management with an overview of selected aspects of their current financial management and to enable timely remedial action where the auditees’ 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 an auditee’s ability to continue its operations in the near future. Based on the analysis, each auditee was given an overall assessment as follows:

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

Figure 1 shows our assessment of the financial health of auditees over the past four years and figure 2 the status in provinces and the national sphere with a comparison to the previous year. The 2015-16 figures have been restated to take into account changes in the indicators used to assess the financial health of auditees. Note also that these two figures include the financial health status of the SOEs to provide an overall picture, but the SOEs are not included in the discussion on the status of public entities as they had already been dealt with in section 4.

Figure 1: Number of auditees with indicators of financial health risks (overall)
The number of auditees we assessed as having a **good financial health status** had increased since **2013-14** (the percentage shows a regression, but it is as a result of a significant increase in the number of auditees being audited since 2013-14). There was also a **slight improvement from 2015-16**. However, the number of **auditees that required intervention doubled in the past four years**, with the main increase being in 2016-17.

As can be seen in figure 2, the provinces with the **highest number of auditees that required intervention** and who had the highest increase from 2015-16 were the Free State (12 auditees) and North West (seven auditees). In the national sphere, the poor quality of the financial statements of the TVET colleges and the concerning financial state of the public entities were the main contributors to the number of auditees requiring intervention.

Only in the Western Cape and Gauteng more than 70% of the auditees had a good financial health status.

We provide further details on the status and main financial indicators of departments and public entities in the remainder of this section. Please also refer to section 16 for a provincial perspective.
Financial health and unauthorised expenditure of departments

Figure 3 provides a four-year view of the financial health of departments and also shows the total budget of the departments within each category.

Since 2013-14, there had been a **regression in the overall financial health of departments**. Although the number of departments with a good status increased slightly from 2015-16, it represented only 36% of the departmental budgets, while the number of departments in financial difficulty almost doubled.

Over the four-year period, 64% of the departments in the Eastern Cape lost their good status, with the Western Cape and Gauteng losing 15% and 13% of departments in this category, respectively. In 2016-17, 92% (12) of the departments in the Free State were assessed as requiring intervention, representing R26.7 billion (98%) of the province’s budget.

The status of **unauthorised expenditure** also provides a view of the financial health of departments.

**What is unauthorised expenditure?**

Unauthorised expenditure refers to expenditure incurred by departments that was not spent in accordance with the approved budget.

Figure 4 depicts the extent of unauthorised expenditure over the past four years and the proportion thereof that was identified during the audit and not by the department.
As reflected in figure 4, 12% of the departments incurred unauthorised expenditure in 2016-17 – the number of departments decreased steadily and the amount decreased by 16% over the four-year period, but significantly increased by 93% since the previous year. A total of 10 (52%) of the 19 departments that had unauthorised expenditure in 2016-17 also incurred such expenditure in the previous year, five of which had incurred such expenditure for the past four years.

Departments in the following provinces were the main contributors to the significant increase in unauthorised expenditure from the previous year:

- Eastern Cape – R175 million (increased from R4 million)
- North West – R105 million (increased from R9 million)
- Mpumalanga – R98 million (increased from R9 million)
- Gauteng – R99 million (increased from R13 million)

Overspending of the budget or main sections within the budget was the reason for 92% (2015-16: 75%) 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. Only 8% of the unauthorised expenditure was as a result of expenditure not being used for its intended purpose (at the Department of Water and Sanitation).

Figure 4 also shows that we had identified only 8% of the unauthorised expenditure amount during the audit process, which means that most of the departments have adequate processes to detect and quantify all unauthorised expenditure. This is encouraging and an improvement from the previous year.

The following departments, mostly in the education and health sectors, were the main contributors (93%) to unauthorised expenditure in 2016-17:

- Department of Water and Sanitation – R407 million (2015-16: R0)
- Education (Free State) – R238 million (2015-16: R157 million)
- Education (Eastern Cape) – R175 million (2015-16: R0)
- Health (North West) – R100 million (2015-16: R0)
• Education (Mpumalanga) – R97 million (2015-16: R0)
• Education (Gauteng) – R81 million (2015-16: R0)
• Education (KwaZulu-Natal) – R79 million (2015-16: R45 million)
• Education (Northern Cape) – R69 million (2015-16: R0)
• Health (Free State) – R68 million (2015-16: R32 million)
• Health (Northern Cape) – R52 million (2015-16: R93 million)

As detailed in section 9.3, inadequate steps taken by accounting officers to prevent unauthorised expenditure constituted one of the most common material findings on compliance. We reported the findings on compliance as material at 11 departments (7%) (2015-16: 12 [7%]) based on the fact that they had incurred the same type of expenditure in the current and previous years as well as our assessment that adequate controls and processes would have prevented it.

Annexure 1 available on our website shows the auditees that had incurred unauthorised expenditure.

We provide further details below on the financial indicators we used to analyse the financial health of departments, but first it is important to understand how the financial analysis of departments is different from that of other auditees and private sector entities.

Departments prepare their financial statements on what is called the modified cash basis of accounting. This means that the amounts disclosed in the financial statements are only what had actually been paid during the year and do not include accruals (the liabilities for unpaid expenses) at year-end. While this is common for government accounting, it does not give a complete view of the year-end financial position of a department.

We believe it is important for management to understand the state of their departments’ finances, which may not be easily seen in their financial statements – hence we annually reconstruct the financial statements at year-end to take into account these unpaid liabilities. It allows us to assess and report to management whether the surpluses they reported are the true state of affairs and whether they have technically been using the following year’s budget as a result of overcommitment in a particular year.

The following legend applies to the figures shown:

|---------|---------|---------|---------|

Figure 5 reflects the number of departments that in the past four 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). We explain what a going concern is in section 4.

Figure 5: Going concern uncertainty

Material uncertainty with regard to ability to operate in future:

- 11% (19)
- 5% (9)
- 6% (9)
- 6% (10)
A going concern uncertainty existed at 18 departments in 2016-17 (which are responsible for over R63 billion of the budget) – a regression from the previous year and a slight regression since 2013-14.

The departments that reported in 2016-17 that they were in serious financial trouble included:

- three health departments (Eastern Cape, Free State and Northern Cape)
- 12 of the 13 departments in the Free State
- the Department of Water and Sanitation (the Water Trading Entity also reported a going concern uncertainty)
- the Independent Police Investigative Directorate.

Figure 6 shows some of the typical indicators of going concern uncertainty over the past four years, in addition to the revenue management and creditor-payment period indicators detailed later on in this section.

In total, 111 departments (68%) technically had insufficient funds to settle all liabilities that existed at year-end if the unpaid expenses at year-end were also taken into account. For most of the departments, this would have a minor impact, but 13 departments started the 2016-17 year with more than 10% of their budget effectively pre-spent. However, as shown in figure 6, if the budget for employee cost is not taken into account, 28 (17%) had spent more than 10% of their 2016-17 operating expenditure budget.

Of these 28 departments, all but six were provincial departments and included four education, five health and five public works departments. Those with the highest spending were Human Settlements (Free State) (70%), Cooperative Governance and Traditional Affairs (Mpumalanga) (63%) and Public Works (KwaZulu-Natal) (54%). The national departments included the Department of Home Affairs (which spent 46% of the 2016-17 budget).

An emerging risk is the increased litigation and claims against health departments in most of the provinces. The departments do not budget for such claims, which means that all successful claims will be paid from funds earmarked for the delivery of health services, further eroding the ability of these departments to be financially sustainable.

As per figure 6, the reconstructed financial statements showed that more than a third of departments incurred a deficit instead of the surplus they reported; 31 (55%) of these departments also incurred a deficit in the previous year. This shows a significant increase over the past four years. Departments in the Northern Cape and KwaZulu-Natal were the major contributors in this regard, while over half of the departments in the Eastern Cape and the Free State had deficits.

A further matter that requires attention is the 29 departments that had an overdraft at year-end (although there had been an improvement over the four-year period and a slight improvement since the previous year).
Departments receive a budget from government as their key source of revenue. Some departments also generate revenue and depend on the collection of that revenue to provide them with the cash to operate. The main indicators relating to the success of these collections are shown in figure 7.

Figure 7: Revenue management

Almost a fifth of departments estimated in their financial statements that more than 10% of the outstanding amounts owed to them would not be paid. This slightly increased over the four-year period.

As part of our analysis, we calculated the average number of days it took departments to collect debt they deemed to be recoverable. Almost a quarter of departments had an average debt-collection period of over 90 days in 2016-17. Although this was only a slight improvement over the four years, it was a good improvement from the previous year.

Poor recoverability and slow collection had the greatest impact in the health sector. Table 1 shows the state of collection of mostly patient fees at provincial health departments.

Table 1: Revenue management in the health sector

<table>
<thead>
<tr>
<th>Province</th>
<th>%</th>
<th>Days</th>
<th>Province</th>
<th>%</th>
<th>Days</th>
<th>Province</th>
<th>%</th>
<th>Days</th>
</tr>
</thead>
<tbody>
<tr>
<td>North West</td>
<td>82</td>
<td>91</td>
<td>Limpopo</td>
<td>95</td>
<td>18</td>
<td>Northern Cape</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>Eastern Cape</td>
<td>79</td>
<td>80</td>
<td>Free State</td>
<td>59</td>
<td>267</td>
<td>Gauteng</td>
<td>41</td>
<td>398</td>
</tr>
<tr>
<td>Western Cape</td>
<td>37</td>
<td>202</td>
<td>KwaZulu-Natal</td>
<td>12</td>
<td>490</td>
<td>Mpumalanga</td>
<td>0</td>
<td>1 290</td>
</tr>
</tbody>
</table>

(% = Percentage of debt that cannot be recovered  Days = Average collection period)

Pressure on the cash flow of departments in turn meant that they took longer to pay their creditors. Figure 8 shows the number of departments with an average creditor-payment period of more than 30 days and more than 90 days over the four-year period.

Figure 8: Creditor-payment period

The number of departments with an extended payment period over 30 days significantly increased over the four-year period and since the previous year. The payment period over 90 days remained stagnant over the four-year period with a slight regression from the previous year.

More than half (54%) of the departments in Mpumalanga had a payment period over 30 days, closely followed by the Eastern Cape at 50% as well as the Free State and the Northern Cape at 46% and the
national departments at 43%. Health and Infrastructure Development in Gauteng on average took the longest of all the departments to pay their creditors at 171 and 129 days, respectively.

As reported in section 9, the inability of auditees to pay within 30 days was one of the most common compliance findings we had raised. Delayed payments affect the cash flow of the suppliers government is doing business with and are in sharp contrast with the objectives of stimulating the economy and supporting especially smaller businesses.

Although delayed payments are typically as a result of poor controls and processes, it can be concluded that the financial difficulty of some departments and the lack of cash to honour their obligations (as described earlier in this section) are also contributing factors in this regard.

Overall, there is an emerging trend of departments failing to manage their finances properly. Some departments are not paying their creditors when their budgets start running out and thereby avoid unauthorised expenditure, but the payments then happen in the following year, effectively using money intended for other purposes. Some departments overspend on their budgets and still have outstanding liabilities at year-end. This continuing ‘rollover’ of budgets is having a negative impact on departments’ ability to pay creditors on time and to deliver services. The education and health departments are affected the most and their inability to deliver services will have an impact on the most vulnerable in society.

The signs of financial failure in the Free State should receive urgent attention. The provincial overview in section 16 provides more detail in this regard.

**Financial health of public entities**

Section 4 discusses the major concerns we have identified regarding the financial health of SOEs. The analysis in this section excludes these SOEs to give a view of the state of the other entities, which include constitutional institutions, government business enterprises, trading entities, other public entities that are not profit-driven, and the TVET colleges.

Figure 9 provides a four-year view of the financial health of these public entities and also shows the total budget of the entities within each category.

![Figure 9: Number of public entities with indicators of financial health risks](image-url)
The percentage of public entities we assessed as having a good financial health status slightly decreased from 67% in 2013-14 to 66% in the current year, but improved from the previous year. Public entities generally performed better than departments, but we are concerned about the public entities in North West (seven of their nine entities had serious financial difficulties and the financial statements of two were so poor that a reliable assessment could not be done but there were indicators of financial problems). Regarding the 45 TVET colleges that we had audited, 16 were of concern and 10 had poor financial statements that could not be assessed reliably. The other public entities that required intervention included the Unemployment Insurance Fund and the Road Accident Fund.

We provide further details below of the main financial indicators used for the assessment of public entities over the four-year period. The following legend applies to the figures shown:

<table>
<thead>
<tr>
<th>Year</th>
<th>2016-17</th>
<th>2015-16</th>
<th>2014-15</th>
<th>2013-14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Material uncertainty with regard to ability to operate in future</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7% (15)</td>
<td>7% (13)</td>
<td>7% (13)</td>
<td>8% (13)</td>
<td></td>
</tr>
</tbody>
</table>

Figure 10 reflects the number of public entities that in the past four 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).

A going concern uncertainty existed at 15 of the public entities in 2016-17 – a slight increase since 2013-14 and 2015-16. This included six public entities in North West as well as the Coega Development Corporation, Road Accident Fund, Public Protector and Water Trading Entity.

Figure 11 shows some of the typical indicators of going concern uncertainty over the past four years, in addition to the revenue management and creditor-payment period indicators detailed later on in this section.
There had been a regression since 2013-14 and a slight regression since the previous year in the number of public entities whose current liabilities exceeded their current assets, which raises a concern over their ability to repay their current liabilities in the short term. This was caused by cash-flow problems (mainly due to poor debt collection and the inability to pay creditors).

During 2016-17, 39% of the public entities incurred a net deficit. These included the Competition Commission, Independent Regulatory Board for Auditors, National Skills Fund, Road Traffic Management Corporation and South African Social Security Agency as well as 56% of the TVET colleges we had audited.

The number of public entities with year-end bank balances in overdraft had remained unchanged since 2013-14.

Even though the majority of public entities that incurred deficits for the financial year would be able to continue their operations, the negative indicators raise concerns about the financial viability of some and the pressure to acquire additional funding from government.

One of the main reasons for the failing financial health of public entities is inadequate revenue management. The main indicators over the past four years in this regard are reflected in figure 12.

Figure 12: Revenue management indicators

<table>
<thead>
<tr>
<th>More than 10% of debt irrecoverable</th>
<th>Debt-collection period of more than 90 days</th>
</tr>
</thead>
<tbody>
<tr>
<td>53% (112)</td>
<td>25% (53)</td>
</tr>
<tr>
<td>51% (97)</td>
<td>21% (40)</td>
</tr>
<tr>
<td>41% (72)</td>
<td>23% (41)</td>
</tr>
<tr>
<td>35% (60)</td>
<td>16% (27)</td>
</tr>
</tbody>
</table>

Just over half of the public entities estimated in their financial statements that more than 10% of the outstanding amounts owed to them would not be paid, which had seen a steady increase since 2013-14. A total of 65 (58%) of these 112 public entities estimated that more than 50% of the outstanding amounts owed to them would not be paid, which included 33 of the TVET colleges as well as the Financial Services Board, National Credit Regulator and Special Investigating Unit.

As part of our analysis, we calculated the average number of days it took public entities to collect debt they deemed to be recoverable. A quarter of the public entities had an average debt-collection period of over 90 days in 2016-17. This was a slight regression from the previous year.

The root causes of long-outstanding debt, which places revenue funds under pressure and affect the ability of public entities to operate, remain poor revenue-collection and debt-management practices and the poor economic climate.

Extended collection periods put the cash flow of public entities under significant pressure, which in turn meant that they took longer to pay their creditors. Figure 13 shows the number of public entities with an average creditor-payment period of more than 30 days and more than 90 days over the four-year period.
Over half of the public entities took more than 30 days to pay their creditors, with limited movement over the four years. These numbers significantly decreased when assessed over 90 days, however, as only 34 auditees took more than 90 days to pay their creditors – a slight increase over the four years but a decrease from the previous year.

Late payments were more common in public entities than in departments. Public entities with extended creditor-payment periods are running the risk of key suppliers discontinuing their services, which may have a significant impact on their operations and ability to deliver services or continue with their business.

**Conclusion**

The budget and performance planning processes should be informed by a solid analysis and forecast based on credible historical information and knowledge of the funding constraints and expected performance pressures. Auditees in financial difficulty should set clear targets for improvement and plan systematically towards achieving these (PLAN).

Financial discipline is required to curtail spending and ensure that the best financial decisions are made. This extends to beyond the chief financial officer and finance unit to procurement practices by all divisions, executive-level decisions and human resource (HR) management, among other (DO).

The financial position of departments will only improve if expenditure is more effectively monitored in-year, as and when incurred (and not just when paid), and by improving systems to promptly account for liabilities incurred. The National Treasury, provincial treasuries and relevant portfolio committees should monitor actual spending patterns and identify the departments with serious cash shortfall issues to intervene where necessary (CHECK).