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# **GENERAL REPORT**

OF THE

**AUDITOR-GENERAL**

ON

**AUDIT OUTCOMES FOR THE FINANCIAL YEAR 2003-04**

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## FOREWORD

What was the status of government's financial management and accountability processes during the 2003-4 financial year? That is the question this general report aims to answer through an overview of the audit outcomes for that period.

As in past reports, I am not simply reflecting on the audit outcomes for 2003-4, but am also, wherever possible, providing and/or enabling some analysis by comparing the results with past years. In order to further improve the understanding of the issues at hand some new analysis has been included in this report. This also serves to address the need expressed by our clients: Parliament, government and the public.

A new feature of this report is section 2, where I am able to report on specialised audits in far more detail than in the past. I have also linked the audit reports to the financial management capability model. These developments are further efforts to improve the relevance of my reporting, making this report more useful for everyone involved.

Two particular areas included are financial management and performance information. Reporting on financial management issues is the bedrock of auditing which highlights material non-compliance with financial rules and regulations, while specialised audits, in particular the additional information on performance, provide a more holistic analysis of the entities I audit.

In last year's Activity Report, I mentioned that we were aiming to give more attention to these two areas in future. I am pleased to be able to provide some analysis on these areas as a starting point in this year's report, with the understanding that there is room for further development.

I trust that both the new developments presented in this report, as well as the ongoing comprehensive analysis of the national departments and national public entities, will once again facilitate effective accountability, while also assisting the entities audited in identifying what works well and what needs attention in their internal accountability processes.

### Executive summary

This report covers the following key areas:

1. Regularity audit outcomes – national departments
2. Audit outcomes of specialised audits
3. High-level regularity audit outcomes – provinces
4. Regularity audit outcomes – national public entities
5. Portfolio summaries – national ministerial portfolios

At the national departments the key findings show that the challenges previously reported are continuing. In fact, the number of qualified audit opinions has increased. This means that accounting officers are still far from meeting the full requirements of the Public Finance Management Act, 1999 (Act No. 1 of 1999) (PFMA). Another element that could contribute to the challenges they are facing, is the ongoing high level of vacancies amongst senior managers within departments. According to my



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analysis the vacancies amongst senior managers continue to be in excess of 20% in many departments.

Another key area of findings is related to asset management, a perennial issue that is not being effectively addressed. In addition, a new area of concern is related to information systems controls by departments, which is linked to the extra focus placed by my office on this area. Basic policies and procedures and key documents are not in place.

Areas where improvement has taken place include the processes around transfer payments, and general management of income and expenditure. This is also reflected in the 14 departments where three or fewer matters were emphasised.

The detailed analysis of the audit outcomes for national departments has been reduced but the audit findings have been analysed and categorised into the financial management capability model framework. I trust that over time this will provide more insight into the reasons for poor performance in terms of financial management.

In section 2, the performance information review (not an audit) highlights fundamental deficiencies in the reporting on performance information in the annual reports. This includes poor linkage to budget commitments, lack of measurable objectives and lack of explanation of deviations from planned targets and outputs. Much work is required in the development of reporting on this area, if we are to achieve effective accountability around service delivery.

At the provincial level, expenditure on the key sectors, namely Health, Social Development and Education, once again exceeded the total budget of the national departments. The total number of qualifications rose to 62% for 2003-04 (from 48% in 2002-03).

An improvement was noted in the submission of their information by public entities. In terms of audit outcomes a similar trend as seen among national departments was identified. The three areas most commonly reported on were non-compliance with regulations, internal audit and audit committees and asset management.

As reported in my previous report, more issues were reported in the audit reports on the public entities when my office conducted the audit. This situation could be improved in future as a result of the additional scope for auditing public entities afforded to me through the promulgation of the Public Audit Act.

**S A Fakie**  
**Auditor-General**

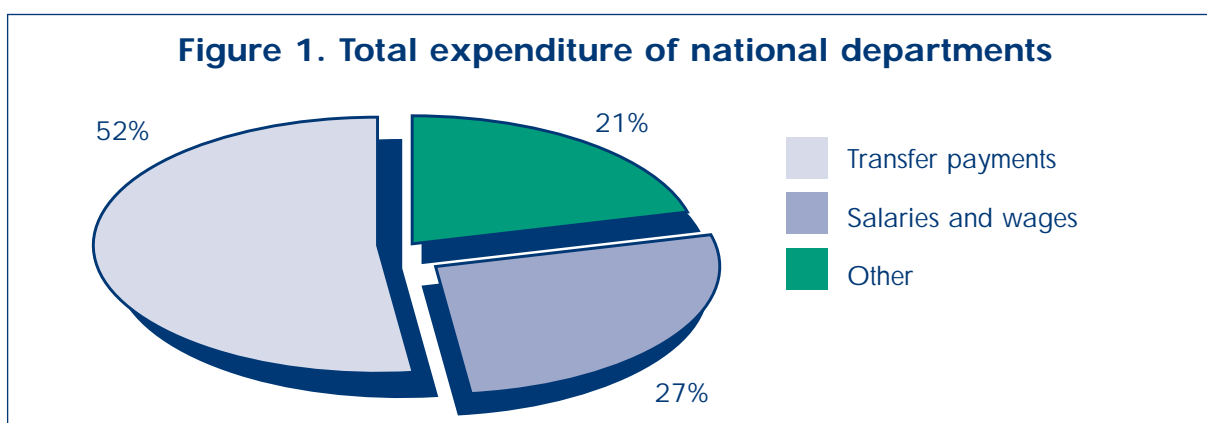
**Pretoria**  
**8 December 2004**



## SECTION 1: NATIONAL DEPARTMENTS

### 1.1 Results of the audits of national departments 2003-04

The total expenditure of national departments during 2003-04 was R134 billion. This is represented by the categories shown in figure 1. The majority of the expenditure (52%) is represented by transfer payments, with personnel expenditure (27%) being the next largest area.



The annual reports of departments, which include the financial statements, were used to extract the following key information:

- Vacancy rates amongst senior management
- Irregular, unauthorised and fruitless and wasteful expenditure

### 1.2 Vacancy rates amongst senior management

**Table 1. Vacancy rates (over 20%) for senior management positions for at least two years**

Department	Vacancy rates for the 2003-04 financial year	Vacancy rates for the 2002-03 financial year	Vacancy rates for the 2001-02 financial year
Public Service and Administration	23,1%	24,2%	22,3%
Provincial and Local Government	61,0%	39,3%	13,9%
National Treasury	32,8%	41,0%	12,5%
Public Enterprises	36,7%	33,0%	32,0%
Public Works	41,2%	35,7%	33,7%
Science and Technology	30,2%	66,7%	55,3%



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The six departments above have now shown a significant trend in terms of the vacancy rates amongst senior management positions. This situation is further compounded by the other departments who in 2003-04 also reported vacancy rates amongst senior staff in excess of 20%, namely:

- Education
- Labour
- Presidency
- Safety and Security
- Trade and Industry
- Transport
- Agriculture
- Home Affairs
- South African Management Development Institute

In total this represents 15 of the 34 national departments (44%) with senior management vacancies in excess of 20%. This, together with the expected increase in economic activities and service delivery in our country, creates serious concern about the long-term ability of these government departments to deliver on their mandates.

### 1.3 Irregular, unauthorised and fruitless and wasteful expenditure

The table below shows the total disclosed expenditure in respect of each category for national departments.

**Table 2. Irregular, unauthorised and fruitless and wasteful expenditure of departments (2003-04)**

Type of expenditure	R million	Number of departments
Irregular	30,2	12
Unauthorised	111,5	5
Fruitless and wasteful	0,4	5
<b>Total</b>	<b>142,1</b>	

The total amount of R142,1 million represents 0,1% of total expenditure. The Departments of Defence (R40,5 million), Trade and Industry (R32,2 million) and Public Works (R30,4 million) showed the largest unauthorised expenditure.

### 1.4 Audit opinions on the national departments

In line with international auditing standards (which my office has adopted) there are two means of highlighting concerns resulting from the audits we do. Firstly, a "qualified audit opinion" (including an adverse opinion and disclaimer of opinion) is provided, where the auditor has identified critical issues that are making it impossible to express an "unqualified" opinion. Secondly, "matters emphasised" can be included to point out certain areas of concern, which do not affect the audit opinion itself.



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The qualified audit opinions for the national departments over the past four financial years are presented in table 3 below. This table shows that the same departments continue the trend of receiving qualified audit opinions as in the past. The notable exception is the Department of Justice and Constitutional Development.

In terms of departments that continue to receive qualified audit opinions, three departments have received qualifications for the past four years. These are:

- Home Affairs
- Public Works
- Water Affairs and Forestry

In addition, Statistics South Africa and the Department of Correctional Services have received a qualified audit opinion for the past three years.

Overall, a total of eleven departments received a qualification in 2003-04. This represents an increase on previous years and suggests that the implementation of policies and procedures by management to satisfy the requirements of, amongst others, the Public Finance Management Act, 1999 (Act No. 1 of 1999) (PFMA) is proving difficult.

**Table 3. Qualifications at national departments – trend over four years**

Vote	2003-04	2002-03	2001-02	2000-01
Home Affairs	✓	✓	✓	✓
Public Works	✓	✓	✓	✓
Water Affairs and Forestry	✓	✓	✓	✓
Correctional Services	✓	✓	✓	
Statistics South Africa	✓	✓	✓	
Defence	✓	✓		
Health	✓		✓	
Minerals and Energy	✓			✓
Parliament	✓			
Safety and Security	✓			
Foreign Affairs	✓			
Justice and Constitutional Development		✓	✓	✓
Labour		✓		
Education			✓	
Communications				✓
Land Affairs				✓
<b>Total</b>	<b>11</b>	<b>8</b>	<b>8</b>	<b>7</b>

### 1.5 Reasons for qualifications

For the purposes of this general report, I am introducing a link between the audit report issues and the financial management capability levels. At this early stage the intention is to categorise findings where they clearly fit into a specific level and identify current limitations for further analysis.



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### 1.5.1 The financial management capability model

There have been several developments in the audit coverage of financial management over the past few years. This has culminated in an approach where I will evaluate all entities against a capability model that is explained in more detail below. The model is based on a capability model developed by the Canadian Audit Office, but has been adapted for our purposes. Further research on integrating the model into the audit process is ongoing.

The model describes six levels of financial management capability:

**Table 4. Financial management capability model**

Capability level	Outline	Detailed characteristics
Level 1 – <i>Start-up level</i>	No proper control framework	<ul style="list-style-type: none"> <li>✓ Mandate and functions of entity not clearly understood</li> <li>✓ Roles and functions not clearly separated from other entities</li> </ul>
Level 2 – <i>Developmental level</i>	A proper internal control framework and financial accounting processes have been developed	<ul style="list-style-type: none"> <li>✓ All elements of policy framework required by management to control the operations of the entity are in existence</li> <li>✓ The implementation of the policy framework designed by management is "adequate"</li> </ul>
Level 3 – <i>Control level</i>	Focus is on compliance and control	<ul style="list-style-type: none"> <li>✓ Officials with appropriate training and capacity can carry out their functions effectively</li> <li>✓ Full compliance with PFMA and other requirements</li> <li>✓ Reliable financial reporting</li> </ul>
Level 4 – <i>Information level</i>	Focus on measuring how resources are used	<ul style="list-style-type: none"> <li>✓ The economic, efficient and effective utilisation of resources is managed, measured and reflected in reliable financial information</li> </ul>
Level 5 – <i>Managed level</i>	Focus on balancing efficient and economical use of resources with quality/effectiveness of results achieved	<ul style="list-style-type: none"> <li>✓ Risk management: cost-effective utilisation of resources</li> <li>✓ Risk management: project costing and financing</li> <li>✓ Continual updating of strategic plans</li> </ul>
Level 6 – <i>Optimising level</i>	Focus on continuous improvement and learning	<ul style="list-style-type: none"> <li>✓ Strategic financial training for non-financial employees</li> <li>✓ Continuous internal assessment of financial management processes, improvements and measurements</li> </ul>



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Issues that were included in the qualification paragraphs have been categorised under *level 2: policy framework*. What this means is that the elements needed for management to have an effective system of internal control, are non-existent.

The responsibility for this omission clearly rests with the accounting officer in terms of the PFMA. Many elements of financial management at the level of policy framework are clearly stipulated in the PFMA, including the consideration of the following key elements:

- Risk assessment, strategic planning and budgeting
- Defined roles, delegations and responsibilities
- Fraud prevention
- Policies/instructions on fundamental areas of income or expenditure (e.g. supply chain management)
- Information systems control environment (creation of secure and reliable information systems to facilitate the integration of the above elements)

*Of the qualification issues raised in the eleven departments, 23% can be ascribed to the lack of a policy framework. Given the huge impact on proper financial management, it is proposed that action plans to address these issues be submitted to the Standing Committee on Public Accounts (SCOPA) by the relevant accounting officer.*

Once the issue of the lack of a policy framework has been addressed, the other aspect of level 2 rests with the "adequacy" of the elements for providing a system of effective internal control. The adequacy of the implementation of the framework could be demonstrated in terms of:

- Integration of all key elements of the internal control structure (e.g. information systems)
- Communication (relevant information is provided to those who need it)
- Updating and maintenance (all changes, updates and enhancements are effected in a holistic manner)

Inadequacies of the elements of a policy framework are not currently defined within, amongst others, Treasury Regulations. This could lead to the situation described as "blind compliance", where a department has all the documentation, but this is not utilised and merely kept to satisfy the legal requirements.

The extent to which this situation of "blind compliance" arises is the area that management and in particular internal audit should be assessing. Due to reasons stated, from the audit report issues it was not possible to distinguish this aspect.

My office and the National Treasury are specifically looking at how deficiencies in the implementation of the policy framework and internal control systems of the entities can be addressed. This would in fact "bring to life" the key requirements of the PFMA in terms of facilitating an effective system of internal control. The intention is to consider reporting on the inadequacies of the policy framework and its implementation in future audits.

Moving on to level 3 issues, the key element here is whether the policy framework, as designed and implemented in the department, is being adhered to by the relevant officials. It is difficult to pinpoint



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the reasons for non-adherence due to the policy framework aspects discussed as level 2 factors. The difficulty in pinpointing the problem lies in being able to identify whether the failure to comply was as a result of either:

- communication, integration, maintenance and updating of policies or monitoring and enforcement (level 2), or
- training or another capacity issue, resulting in the individual responsible not being able to carry out the function (level 3).

The first issue involves redesigning and updating processes, including ensuring that the necessary tools and equipment are available to support the process. The second issue relates to human resource management in the areas of training and capacity building.

### **1.6 National departments: Matters emphasised**

Although the qualifications expressed are a matter of great concern, the matters emphasised are also a crucial guide to the issues that require attention at the departments. The analysis of the departments shows that only the following departments had no matters emphasised in their reports, resulting in "clean reports" representing R1,6 billion or 1,2% of total national department expenditure:

- Environmental Affairs and Tourism
- Public Enterprises
- Public Service Commission

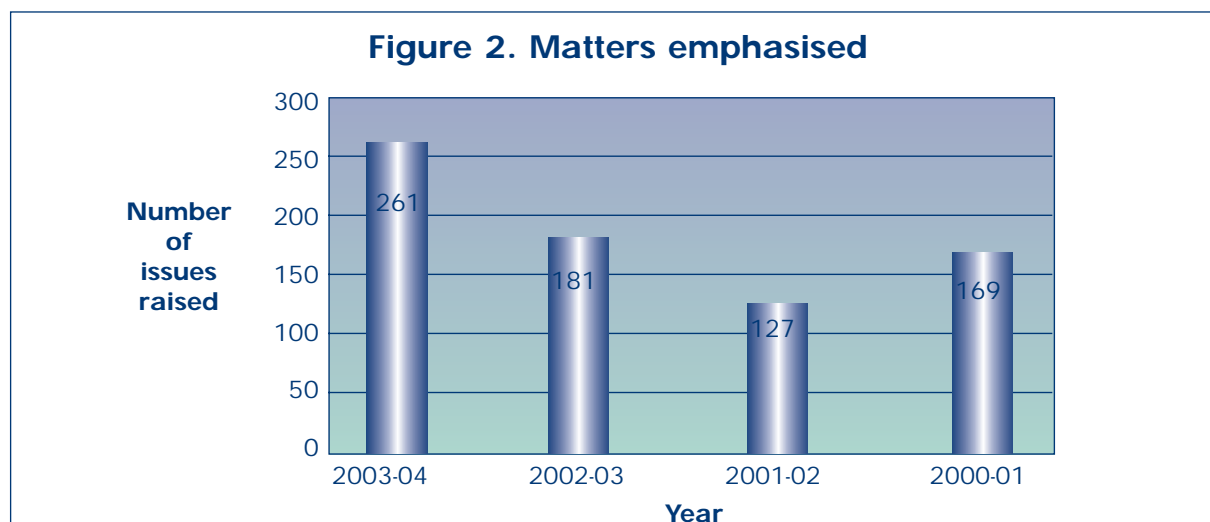
In the case of the remainder of the departments there were eleven reports that had three or fewer issues reported as matters emphasised. These departments, representing R34,8 billion or 25,9% of total national departmental expenditure, were:

- Trade and Industry
- Independent Complaints Directorate
- Sport and Recreation
- Science and Technology
- Presidency
- Government Communication and Information System
- Housing
- Education
- Communications
- National Treasury
- Public Service and Administration
- Social Development

Despite the improvement noted in certain departments, the overall picture suggested that the items reported were increasing. The situation shows that the number of items raised under matters emphasised has increased over the past three years, with fewer than 150 items in 2001-02 to over 250 items in 2003-04. Figure 2 below provides information on the trend for the past four years.



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In terms of the paragraphs dealing with matters emphasised, the issues are categorised into the following most commonly reported areas:

- Asset management
- Income statement
- Information systems
- Internal audit and audit committee

To some extent this increase in matters emphasised is linked to the increasing demands placed on disclosure notes as departments are expected to migrate to accrual accounting. The accounting and control over assets is proving particularly problematic, as demonstrated below.

Table 5 below shows the frequency of issues reported and the coverage of the four main categories.

**Table 5. Analysis and classification of emphasis of matter issues into categories**

Issue	Number of items 2003-04	Number of items 2002-03	Reference to annexure
Asset management	78	41	2.2.2
Income statement	41	38	2.2.4-2.2.7
Information systems	65	14	2.2.1
Internal audit and audit committees	16	17	2.2.3
Other	61	68	2.2.8
<b>Total</b>	<b>261</b>	<b>178</b>	

The four main categories cover 77% of total findings. At this stage, asset management remains the most frequently reported issue. However, there has been an increase in information systems items reported, from 14 items in 2002-03 to 65 in 2003-04. This represents a significant increase. This increase should not simply be interpreted as a deterioration in the general controls, but also represents the fact that my office focused more closely on this area. In my previous report [RP 214/2003] I referred to the program change control findings surrounding the transversal systems. As this situation is still an area for concern, the focus has moved to the individual departments and their general controls.



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### 1.7 Asset management

As mentioned earlier in this report, the information provided suggests that asset management remains the major challenge for effective internal control. Typical items here included the following:

- Assets registers not kept up to date
- Asset counts not performed
- Assets could not be verified to the ledgers
- Reconciliation of additions within the financial statements

While the number of items has doubled from the previous year, this may be ascribed to the detail provided in the reports of the departments concerned. In 17 departments items were raised regarding asset management. This represents 50% of all departments, but it is also an improvement on 2002-03 where a total of 21 departments had items related to asset management – 64% of all departments. However, despite this improvement, the situation still remains an area of grave concern.

Although issues of asset management are persisting, most of the 78 items appear to fall beyond the simple issue of lack of a policy framework. They relate to the "adequacy" of the asset register and other factors. This implies that the process of managing, maintaining and updating asset registers is the underlying problem.

The National Treasury is well aware of the need for effective asset management and as a result has issued guidelines to assist departments in improving their asset management. A very good link between the importance of asset management and the provisions of the PFMA is provided in the extracts from the Treasury guideline below:

"Financial accounting is not an end in itself, and the managers of assets will require other information to measure some aspects of asset performance such as functionality and utilisation. There is a close correlation between financial management and other measures associated with asset performance and managers need to have a good understanding of the fundamental financial management and accounting concepts that apply...

... it is clear that the proper management of and accounting for assets have been set as an important responsibility of the accounting officer. To give effect to this it is necessary to firstly identify all assets under the control of an entity through reference to original documentation and physical counts and secondly to create a system that will ensure continued monitoring of these assets as well as accounting for additional assets procured on an ongoing basis.

It is very important to note therefore, that the need to have effective Asset Management and to compile a complete Asset Register is not as a result of a change to 'Accrual Accounting' but as a result of legislation enacted as far back as 1999, and based on good financial management practices."

*Source: Asset Management Guideline – National Treasury*

### 1.8 Income statement

This is a broad area and covers a number of issues such as:

- Personnel



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- Transfer payments (including the Division of Revenue Act)
- Income

As was demonstrated in figure 1, personnel and transfer payments represent 79% of total departmental expenditure. Therefore the relatively small number of items and the improvement is encouraging in terms of the progress made by accounting officers.

## 1.9 Information systems

A further area of concern is the emergence of information systems issues. These mainly concern the general controls operated within the departments and include the following areas:

- User account management
- Information technology security policy
- Disaster recovery plan
- Backup and recovery

This illustrates that whilst problems were noted in the central controls over the transversal systems, as identified in my previous general report, similar issues apply to individual departments. It is crucial that practices are put in place to rectify this as a matter of urgency.

From the items identified, around 69% could be attributed to an incomplete policy framework. This means that management had not as yet put in place the necessary minimum policies and procedures to govern such a critical area.

In my previous report [RP214/2003] I provided information on the general controls operated at the National Treasury and the fundamental problems preventing the auditors from being able to rely on the information within BAS and PERSAL. I am pleased to report that in my follow-up audit I was able to place moderate reliance on these systems and note the improvements made.

## 1.10 Internal audit / audit committee

The reporting issues relating to internal audit and audit committees have decreased from 17 items in 2002-03 to 16 in 2003-04. The types of issues reported, however, are of a similar nature in both years.

The issues reported revolve around two factors:

- the internal audit functions did not carry out their planned workload for various reasons including capacity constraints; and
- internal audit functions were not fully functional.

The items raised are concerned more with the capacity and functional effectiveness of the internal audit than a difference in the scope of internal and external audit.