3 The status of financial management

3.1 Financial statements

Figure 1 provides a five-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 materially misstated (red line).

Figure 1: Audit of financial statements

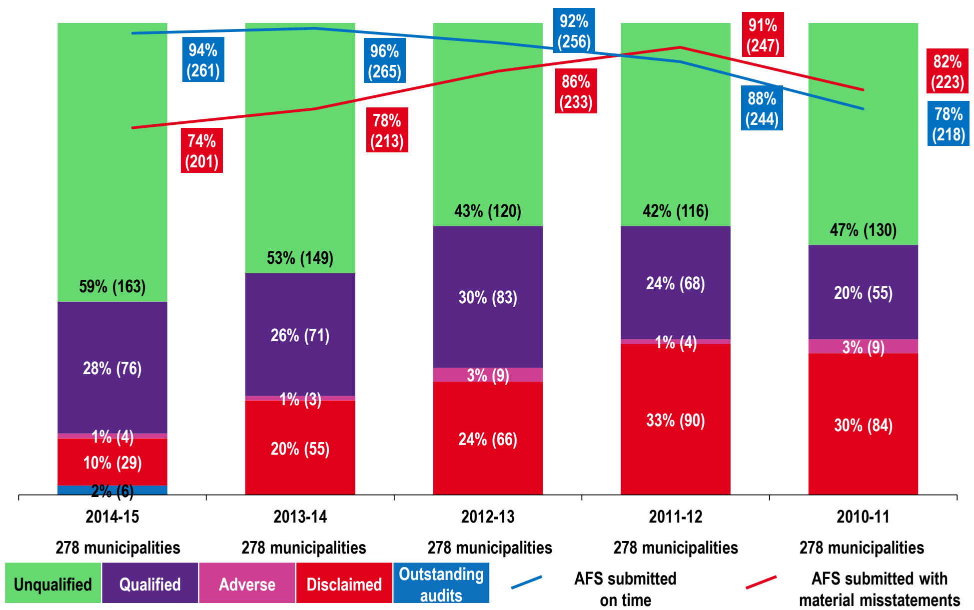


Figure 1 indicates that 94% of municipalities had submitted their financial statements for auditing by 31 August 2015 (or by 30 September 2015 in the case of consolidated financial statements) as required by legislation. The submission rate has improved over the five-year period from a low 78% in 2010-11. The biggest improvement was noted in North West from 2011-12 where the provincial treasury appointed consultants to prepare the annual financial statements.

Figure 1 further shows that the audit opinion on the financial statements had improved since 2010-11 to 59% unqualified opinions in 2014-15, but that 74% of the municipalities were unable to provide auditors with annual financial statements that contained no material misstatements. This means that 92 municipalities (34%) received a financially unqualified audit opinion only because they corrected all the misstatements we had identified during the audit. A total of 109 municipalities were unable to make the necessary corrections to their financial statements, which resulted in qualified, adverse or disclaimed audit opinions.

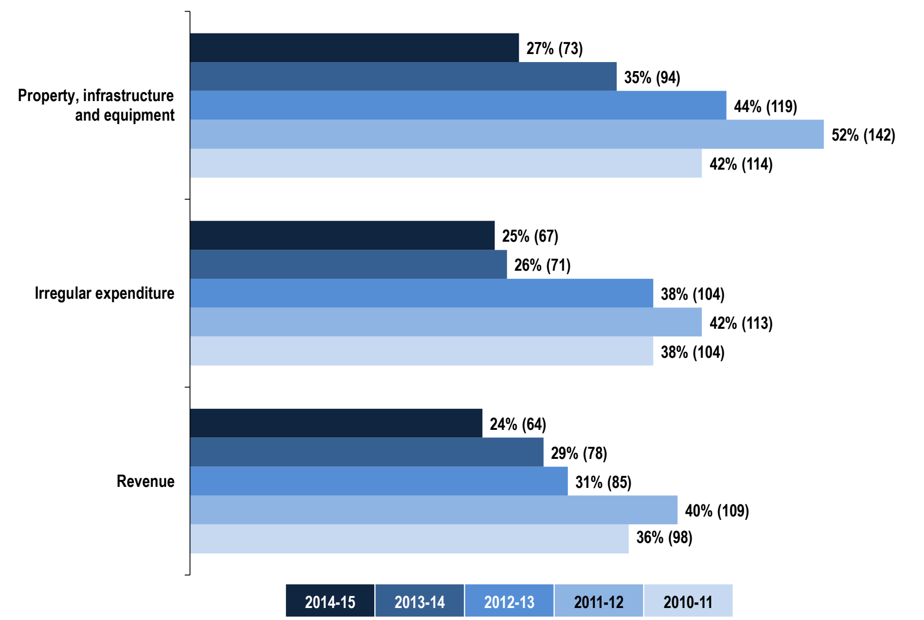
The main reason for not making corrections was the unavailability of information, or incomplete information or documentation to determine the correct amounts to be reflected in the financial statements.

The regression in 2011-12 and lack of improvement in 2012-13 were as a result of challenges with implementation of the GRAP 17 standard (as described later in this section) and inadequate capacity and skills in the finance departments, partly due to instability in municipal leadership (including chief financial officer positions) after the election in 2010-11.

Improvements in 2014-15 were noted in the Eastern Cape, Free State, Mpumalanga and North West. These improvements can be ascribed to improved records management, responsiveness by political leadership, support from the provincial treasuries and the use of consultants to assist with the preparation of annual financial statements and asset registers.

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 over the five-year period.

Figure 2: Three most common financial statement qualification areas



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

Figure 2 indicates that the number of municipalities whose financial statements were qualified on property, infrastructure and equipment had decreased by 22% since the previous year and by 36% since 2010-11, which represents a significant improvement. The municipalities in the Western Cape, KwaZulu-Natal, North West, Free State, Eastern Cape and Gauteng were the main contributors to the improvement, which in the main resulted from improvement in record-keeping controls and the assistance provided by consultants with the preparation of asset registers and valuation of infrastructure assets.

The accounting standard on property, infrastructure and equipment (GRAP 17) became fully effective for low-capacity municipalities in 2011-12. Although these municipalities were allowed a three-year transitional period to prepare for the measurement of their assets in accordance with the accounting standard, many could not account as required, which led to a significant increase in qualified audit opinions in 2011-12.

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

Figure 2 shows that the number of municipalities qualified in this area had decreased by 6% since the previous year and by 36% since 2010-11. The municipalities in the Free State, Gauteng, Limpopo, North West and Northern Cape were the main contributors to the improvement. The reasons for the improvement are improved controls to detect irregularities in the SCM processes and projects undertaken by the municipalities to identify and quantify irregular expenditure incurred in previous years. These projects were implemented at most municipalities by consultants and often with the support of provincial treasuries and CoGTAs.

The improvement in disclosure of irregular expenditure is one of the reasons for the increase in irregular expenditure over the past five years, as discussed in section 3.2.1.

The main reason for municipalities being qualified on **revenue** was that they failed to disclose in their financial statements all revenue earned or had calculated the revenue amounts incorrectly.

Figure 2 illustrates that the number of municipalities qualified in this area had decreased by 18% since the previous year and by 35% since 2010-11. The municipalities in the Western Cape, Eastern Cape, Free State, Gauteng and North West were the main contributors to the improvement that was achieved due to an improvement in revenue management and record-keeping controls. Some municipalities appointed consultants to assist in implementing systems and controls as well as addressing prior year qualifications.

CoGTA launched **operation clean audit** on 16 July 2009 with a vision that all municipalities should achieve financially unqualified audit opinions. The programme included milestones up to 2013-14, by which date all municipalities should have achieved unqualified audits. Although the goal was not achieved, the operation clean audit initiatives launched by provinces and supported by the premiers, provincial treasuries and CoGTAs had a significant impact on the ability of municipalities to improve their audit opinions, most notably in 2013-14.

The **MTSF** set new targets for improving the audit outcomes in pursuit of sound financial and administrative management. The ministers of Finance and CoGTA are responsible for the actions and outcomes in this area, while CoGTA's **back-to-basics strategy** contains a further commitment in this regard. The targets set for 2018-19 are as follows:

- No municipalities with disclaimed or adverse opinions
- A maximum of 25% of municipalities with qualified opinions
- At least 75% of municipalities with unqualified opinions.

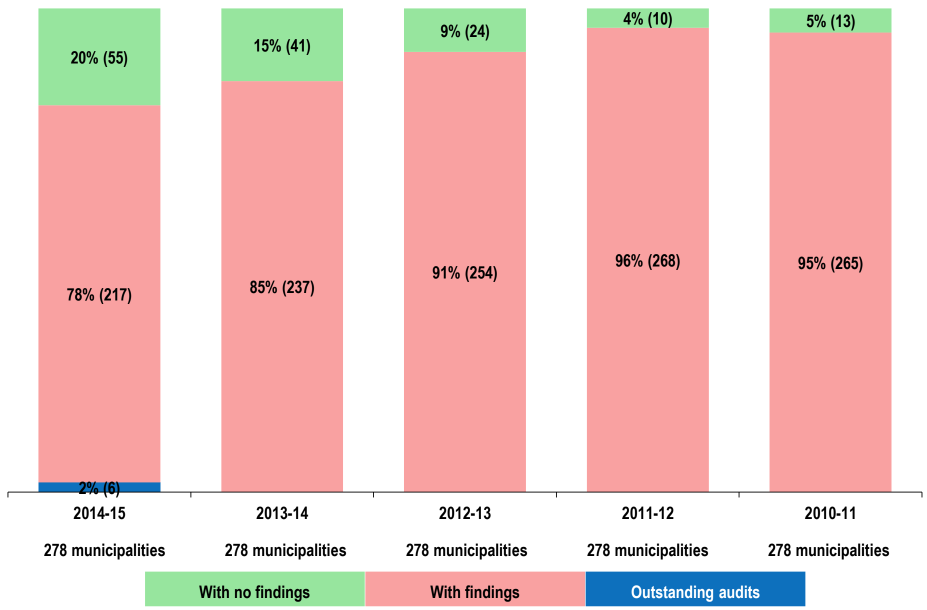
The percentage of municipalities with unqualified audit opinions in 2014-15 was 59% against the target of 75% as per the MTSF targets, while the municipalities with qualified opinions stood at 28% against the MTSF targets. In 2014-15, 11% of municipalities received disclaimed or adverse opinions against the target, namely that no municipalities should have these type of opinions by 2018-19. The continuous improvement in audit opinions on the financial statements, especially in the past year, is an encouraging sign that the targets for 2018-19 are not out of reach.

However, 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 5.3 for further details on the extent of the use of consultants.

3.2 Compliance with key legislation

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

Figure 1: Municipalities with findings on compliance with key legislation



While the five-year trend reflects an improvement, municipalities' non-compliance with key legislation remained at a high level. Over this period the number of municipalities with findings decreased for all municipality types, chiefly at metros (from all eight to five) and district municipalities (from 91% to 63%). The number of municipalities with findings on compliance decreased in all provinces except Mpumalanga and Limpopo, which remained at the same level.

The biggest increase in the number of municipalities with no compliance findings occurred in 2013-14 when all provinces improved except the Free State, Limpopo and North West.

Our audits in 2014-15 did not include an assessment of the financial impact of the non-compliance by municipalities, but based on the nature of the compliance findings, we determined that 95% of the non-compliant municipalities have a risk of financial loss as a result of the non-compliance. It is the role of the municipal management and 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, avoidable penalties and interest, etc.

Two hundred and seven of the 217 municipalities (95%) with material findings on compliance in 2014-15 had findings with a potential negative financial impact or findings which could cause a financial loss for the municipality or government.

Figure 2 shows the compliance areas with the most material findings in the current year and the progress made in addressing these since 2010-11. The movement in the area of consequence management is shown from 2012-13 when it became a specific focus area in our audits.

Figure 2: Most common areas of non-compliance

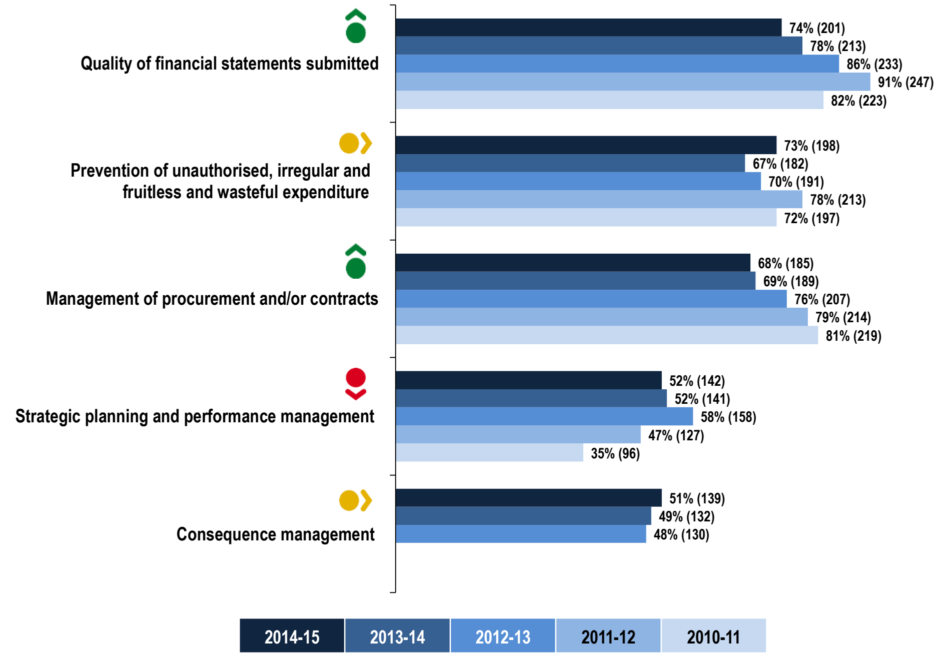


Figure 2 illustrates that over the past five years, material misstatements in submitted financial statements, management of procurement and contracts, and the prevention of unauthorised, irregular as well as fruitless and wasteful expenditure have consistently been the areas where most compliance findings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

We report non-compliance with regards to **material misstatements** only in certain circumstances, as explained in section 11. Section 3.1 provides more information on the improvement in this area.

There has been a slight regression in the **prevention of unauthorised, irregular and fruitless and wasteful expenditure** since 2010-11. After slow improvement every year since 2011-12, there was a significant regression in 2014-15. Section 3.2.1 to 3.2.3 provides more information on the movements in this area.

Material findings on compliance with legislation in respect of **procurement and contract management** (also referred to as supply chain management) have decreased every year since 2010-11, with only a slight decrease in 2014-15. Section 3.2.1 provides more information on the findings and improvements in this area.

The scope of our audit of compliance with the MFMA and Municipal Systems Act (MSA) in respect of **strategic planning and performance management** has increased since 2010-11, which in part is the reason for the regression shown in figure 2. Progress in addressing non-compliance in this area has been slow, which contributed to the poor audit outcomes on annual performance reporting (refer section 4). The most common finding in 2014-15 was that municipalities did not maintain effective, efficient and transparent systems of internal control for managing their performance (37%).

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 non-compliance in this area since 2013-14. The most common finding in 2014-15 was that irregular expenditure was not investigated to determine whether any person was liable for the expenditure (86% of those that incurred irregular expenditure). Section 3.2.4 provides further details on consequence management.

In the remainder of section 3.2 we provide further details of compliance findings relating to SCM and unauthorised, irregular and fruitless and wasteful expenditure.

3.2.1 Weaknesses in supply chain management as a driver of irregular expenditure

As part of our SCM audits in 2014-15, we tested 6 901 contracts (with an approximate value of R50 793 million) and 13 202 quotations (with an approximate value of R771 million), also referred to as *awards* in the rest of the report. More information on the audit we performed is included in section 11.

Figure 1 depicts the number of municipalities that had SCM findings and those where we have reported material findings on compliance in the audit report since 2011-12. Although we have been reporting on SCM practices since 2009-10, our audit approach has been fully developed and has been consistently applied since 2011-12, which makes a four-year comparison most suitable.

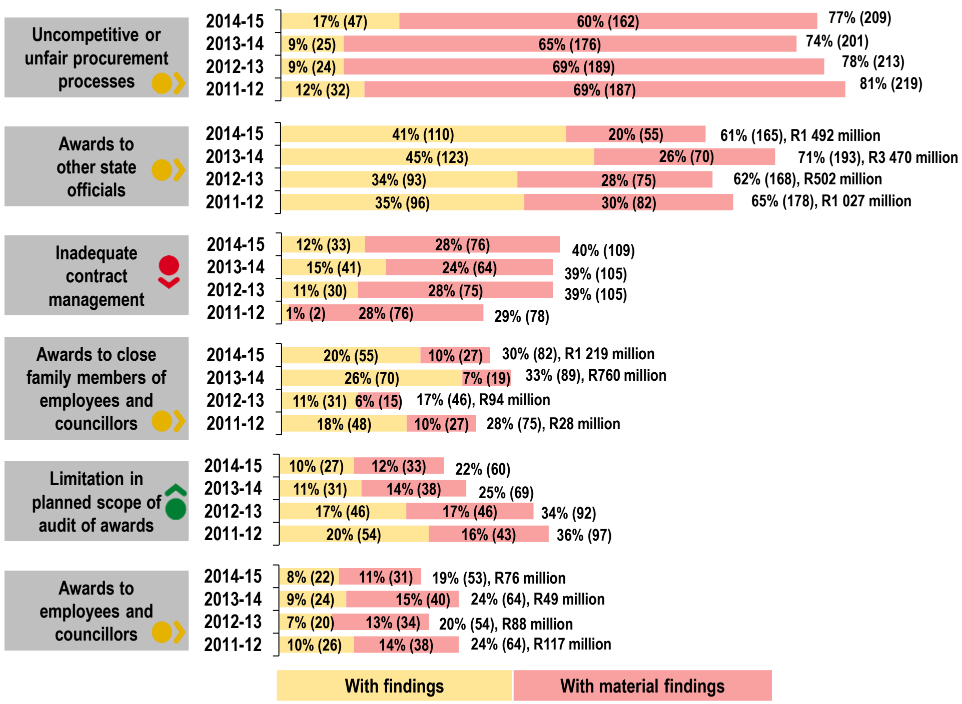
Figure 1: Status of supply chain management

The overall status of municipalities with SCM findings improved only slightly since the previous year – the number of municipalities with no SCM findings is at the same level as in 2011-12. The overall reduction in the number of municipalities with material findings since 2011-12 is a definite sign that municipalities are paying closer attention to SCM, but it remains concerning that two-thirds of the municipalities had material SCM findings, as shown in figure 2.

Not all non-compliance has a financial impact, but some legislative requirements, if not met, will result in the municipality facing a risk of financial loss through excessive expenditure (uneconomical use of funds), fruitless and wasteful expenditure, lost revenue, failure to recover debt, avoidable penalties and interest, etc. One hundred and fifty-one of the 185 municipalities (82%) with material SCM findings in 2014-15 had findings with a potential negative financial impact or findings that could cause a financial loss for the municipality or government.

Figure 2 provides a four-year overview of 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, other state officials and close family members of employees.

Figure 2: Findings on supply chain management



The level of findings in all SCM areas remained almost unchanged over four years except that of inadequate contract management, which regressed, and limitations which have significantly improved since 2011-12.

In the remainder of this section we discuss further the outcomes of our audits in the different SCM audit focus areas and the movement over the four years. Section 11 provides additional information on what is audited in each focus area and the impact of the findings raised.

Limitations on our planned scope of audit of awards

In 2014-15 we were unable to audit awards to a value of R3 131 million at 60 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 1 lists the extent of limitations in the different provinces over four years.

Table 1: Provincial breakdown of limitations encountered

Province	2014-15		2013-14		2012-13		2011-12	
	Municipalities	Amount R million	Municipalities	Amount R million	Municipalities	Amount R million	Municipalities	Amount R million
Eastern Cape	11	372	18	339	14	1 182	22	696
Free State	3	223	8	72	10	243	8	212
Gauteng	3	1 250	3	85	2	8	0	0
KwaZulu-Natal	13	183	8	191	12	274	13	100
Limpopo	7	99	8	86	13	216	14	367
Mpumalanga	3	653	5	185	8	77	10	343
Northern Cape	2	41	7	35	16	118	14	146
North West	11	299	10	440	16	799	13	312
Western Cape	7	11	2	21	1	0	3	4
Total	60	3 131	69	1 454	92	2 917	97	2 180

While the 2014-15 limitations constitute only a slight improvement since the previous year, there has been a significant improvement over the past four years as listed in table 1.

The impact of these limitations was the following:

- 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, the true extent of irregular expenditure could not be determined.

- Our general reports, 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 and councillors, their close family members and other state officials

Figure 2 reflects the following:

- There has been a slight reduction since the previous year and also since 2011-12 in the number of municipalities that had findings on awards made to **suppliers in which employees and councillors had an interest.** The value of these prohibited awards varied over the four years as it depends on the value of the relevant contract awarded in the year.
- There has been a significant reduction since the previous year in the prevalence of awards made to **suppliers in which other state officials had an interest**. The municipalities in Gauteng, Eastern Cape, Limpopo and Northern Cape were the main contributors to the improvement, which was due to greater awareness of the requirement to submit declarations and the insistence by municipalities that the declaration of interest be signed before tenders are awarded. However, there has been only a slight improvement since 2011-12. The value of awards also varied over the four years but represents the highest portion of awards that municipalities are not allowed to make.
- The number of municipalities with findings on awards made to suppliers **in which close family members of employees and councillors had an interest** has decreased slightly since the previous year, but showed a slight increase over the four-year period. The municipalities in Gauteng, Eastern Cape, Free State, North West, KwaZulu-Natal, Mpumalanga and Northern Cape were the main contributors to the significant increase in findings in 2013-14, which was caused by inadequate controls to ensure that officials declared whether their close family members, partners and associates have interests in suppliers and an unwillingness by the municipalities to deal with those employees who failed to disclose the interests of their close family members, partners and associates. The value of these awards appears to have increased over the four years.

Uncompetitive or unfair procurement processes

Figure 2 also shows that the number of municipalities with findings on uncompetitive or unfair procurement processes has decreased slightly since the previous year although there is a slight reduction when compared to 2011-12.

The number of material findings remained high, but had decreased over the four-year period.

The most common findings on the procurement processes in the past four years were as follows:

- **Three written quotations were not invited** for procurement below R200 000 and the deviation was not approved, or the approved deviation was not reasonable or justified – reported at 131 municipalities (2013-14: 138 municipalities; 2011-12: 157 municipalities)
- **Competitive bids were not invited** for procurement above R200 000 and the deviation was not approved, or the approved deviation was not reasonable or justified – reported at 94 municipalities (2013-14: 84 municipalities; 2011-12: 96 municipalities)
- Procurement from suppliers who had not provided evidence that their **tax affairs** were in order – reported at 80 municipalities (2013-14: 88 municipalities; 2011-12: 88 municipalities)
- The **preference point** system was not applied when selecting suppliers – reported at 63 municipalities (2013-14: 69 municipalities; 2011-12: 82 municipalities)
- **Declarations of interest** were not submitted by suppliers at 105 municipalities (2013-14: 65 municipalities; 2011-12: 100 municipalities).

Inadequate contract management

As illustrated in figure 2, findings on contract management have increased slightly since the previous year, but a significant regression was evident since 2011-12. The municipalities in the Eastern Cape, Mpumalanga, Limpopo and Northern Cape were the main contributors to the regression, which was caused by a lack of consequences for transgressors, weak controls around contract management, a lack of SCM contract monitoring, as well as vacancies in the position of head of SCM unit. As shown in figure 2, the proportion of material findings remained high (76 municipalities [28%]), with a slight increase compared to the previous year.

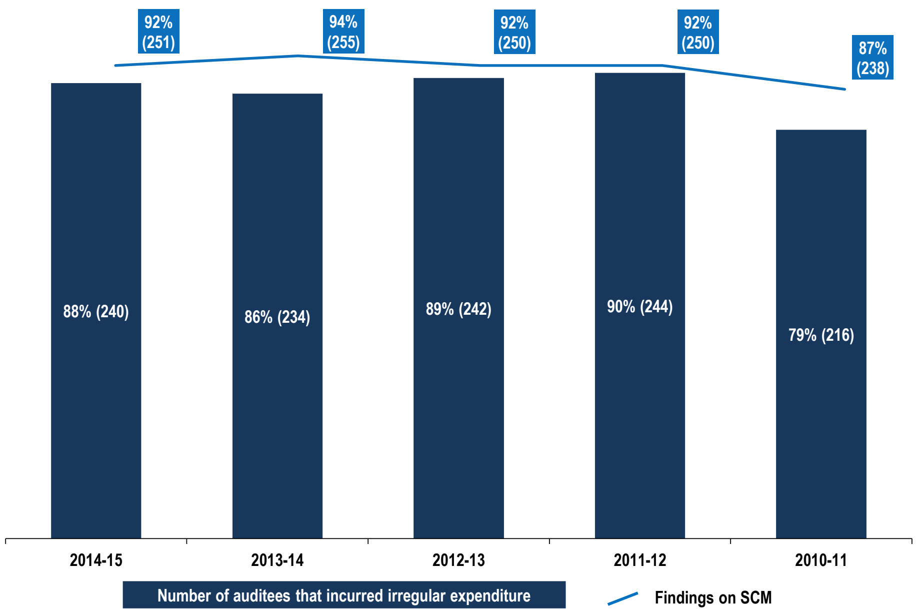
The most common findings on contract management processes in the past four years were as follows:

- The performance of contractors was **not monitored on a monthly basis** – reported at 65 municipalities (2013-14: 37 municipalities; 2011-12: 46 municipalities)
- A lack of or inadequate **contract performance measures and monitoring** – reported at 62 municipalities (2013-14: 40 municipalities; 2011-12: 34 municipalities)

- Contracts were **amended or extended without the reasons being tabled** in the council – reported at 36 municipalities (2013-14: 31 municipalities; 2011-12: 23 municipalities)
- Contracts were **amended or extended without approval** by a delegated official – reported at 35 municipalities (2013-14: 23 municipalities; 2011-12: 19 municipalities).

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. Attention paid in this regard will also address the very high amounts of irregular expenditure incurred annually. Figure 3 depicts the number of municipalities with SCM findings (whether reported in the audit report or only in the management report) and the number of municipalities that incurred irregular expenditure over five years.

Figure 3: Irregular expenditure vs supply chain management findings



Although not all non-compliance with SCM legislation results in irregular expenditure (hence there are slightly more municipalities with SCM findings than irregular expenditure), the figure highlights the correlation between poor SCM practices and the high occurrence of irregular expenditure in local government. Typically, SCM findings such as failure to perform a risk assessment of the SCM system or review the implementation of the SCM policy on an annual basis would not result in irregular expenditure.

Irregular expenditure

Irregular expenditure is expenditure that was not incurred in the manner prescribed by legislation. Such expenditure does not necessarily mean that money had been wasted or that fraud had been committed. However, it is an indicator of irregularities in processes followed in the procurement of goods and services and a measure of a municipality's ability to comply with legislation relating to expenditure and procurement management. These indicators need to be subjected to further scrutiny by management and oversight structures at a municipal level.

Figure 4 shows the five-year trend in irregular expenditure, also indicating the percentage of irregular expenditure identified by the municipalities vs that identified by the audit process.

Figure 4: Five-year trend in irregular expenditure

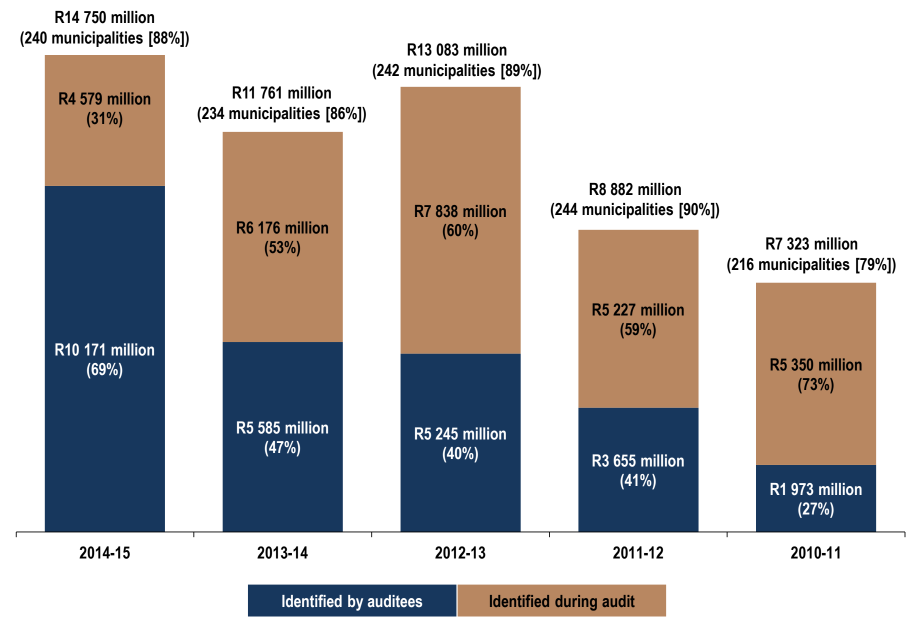


Figure 4 shows that irregular expenditure had doubled in monetary terms since 2010-11, increasing by 25% (R2 989 million) compared to the previous year. It further shows that the number of municipalities incurring such expenditure over the five-year period has remained at 79% or higher. A total of 219 (91%) of the

240 municipalities also incurred irregular expenditure in the previous year, 172 (72%) of which had incurred such expenditure for the past five years.

Municipalities in North West, Mpumalanga, Eastern Cape and Limpopo were the main contributors to the significant increase in irregular expenditure over the five years, which was caused in part by municipalities addressing prior year qualifications (thus not a breakdown in controls in the current year) as well as weak SCM practices.

The following municipalities were the main contributors (43%) to irregular expenditure in 2014-15:

- Rustenburg (NW): R3 062 million – 2 645 instances (2013-14: R195 million – 31 instances)
- Nelson Mandela Bay metro (EC): R1 348 million – 142 instances (2013-14: R1 052 million – 4 982 instances)
- City of Tshwane metro (GP): R1 100 million – 11 instances (2013-14: R150 million – 11 instances)
- Buffalo City metro (EC): R479 million – 359 instances (2013-14: R409 million – 77 instances)
- uThukela district (KZN): R324 million – 1 239 instances (2013-14: R107 million – 114 instances).

The irregular expenditure incurred by the main contributors listed above was 100% supply-chain related except for the Nelson Mandela Bay metro and City of Tshwane metro. The irregular expenditure incurred by the City of Tshwane metro was 97% supply-chain related, while that of Nelson Mandela Bay metro was almost 100% supply-chain related (i.e. less than 1% was not supply-chain related).

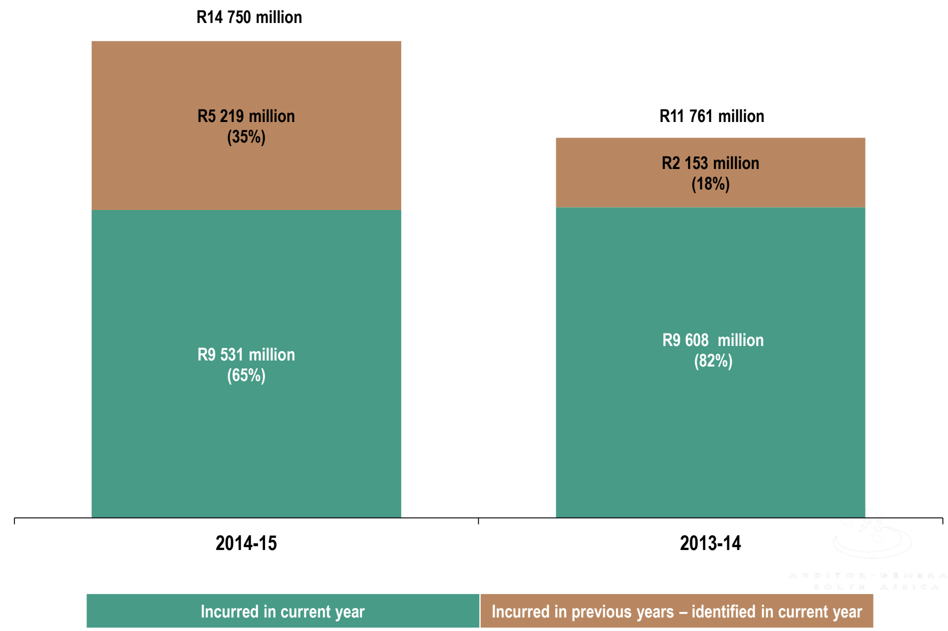
Ninety-four municipalities (35%) disclosed in their financial statements that they had incurred irregular expenditure, but the full amount was not known as they still had to determine whether non-compliance of a similar nature had occurred in the current and previous years. This means that the amount of irregular expenditure for 2014-15 could have been higher if these investigations had been completed by year-end.

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 – R3 508 million (24%) (2013-14: 39%, R4 306 million)
- Non-compliance with procurement process requirements – R10 058 million (70%) (2013-14: 53%, R5 911 million)
- Non-compliance with legislation relating to contract management – R792 million (6%) (2013-14: 8%, R944 million).

Figure 5 indicates the proportion of irregular expenditure disclosed that was incurred in a previous year.

Figure 5: Prior year irregular expenditure identified in current year



R3 339 million of the irregular expenditure shown in figure 5, as incurred in previous years, was as a result of municipalities reviewing the extent of their prior year irregular expenditure and fully recognising it to address a qualification on the completeness of irregular expenditure disclosed in their financial statements in previous years.

As detailed in the previous section on compliance, 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 188 municipalities (69%), based on the fact that they incurred irregular expenditure in the current and previous years, a recurrence of the transgressions that had caused the irregular expenditure, and on our assessment that adequate controls and processes would have prevented it.

Figure 4 shows that we had identified 31% of the irregular expenditure of 2014-15 during the audit process, which means that a number of municipalities did not have adequate processes to detect and quantify all irregular expenditure.

However, this is a significant improvement compared to the 73% in 2010-11 as well as the 53% in the previous year.

The MFMA provides steps that municipal managers and councils should take to investigate irregular expenditure to determine whether any officials are liable for the expenditure and to recover the money if liability is proven. The investigation should also confirm whether fraud had been committed or money had been wasted. The investigations are typically performed or oversight is provided by the MPAC.

We did not investigate the irregular expenditure as that is the role of the municipal manager and council. However, through our normal audits we determined that goods and services were received for R10 810 million (75%) of the R14 358 million in irregular expenditure relating to SCM compliance, despite the normal processes governing procurement not having been followed. However, we cannot confirm that these goods and services had been procured at the best price and that value was received for the money spent.

3.2.2 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.

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

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

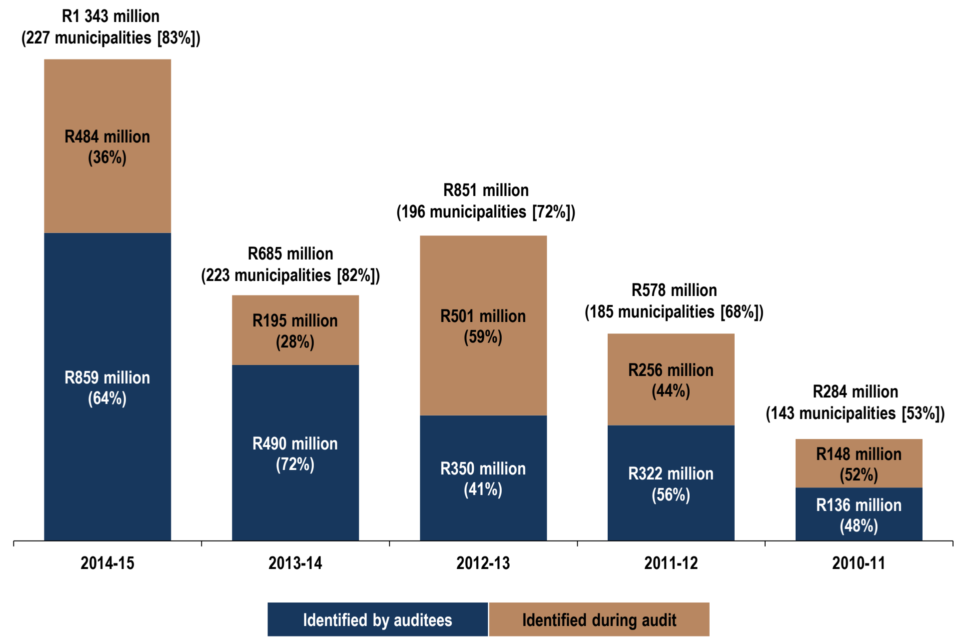


Figure 1 shows a significant increase of R658 million (96%) in the amount of fruitless and wasteful expenditure since the previous year, as well as an increase of R1 059 million (373%) compared to 2010-11. The number of municipalities that incurred this expenditure has also increased by more than 50% since 2010-11. A total of 206 municipalities (91%) incurred fruitless and wasteful expenditure in the current as well as in the previous year, close to half (98) of whom had incurred such expenditure for the past five years.

Municipalities in the provinces of Mpumalanga, Eastern Cape, North West, Free State and Northern Cape were the main contributors to the significant increase in fruitless and wasteful expenditure over the five years.

The following municipalities were the main contributors (59%) to fruitless and wasteful expenditure in 2014-15:

- Nelson Mandela Bay metro (EC): R423 million – 10 instances (2013-14: R11 million – seven instances)
- Matjhabeng (FS): R152 million – 32 instances(2013-14: R103 million – one instance)
- Emalahleni (MP): R95 million – 40 instances (2013-14: R56 million – 40 instances)

- Maluti-A-Phofung (FS): R78 million – 113 instances (2013-14: R32 million – 59 instances)
- Thaba Chweu (MP): R36 million – 322 instances (2013-14: R29 million – 4 instances).

These municipalities are among those that had incurred such expenditure for the past five years, except for Thaba Chweu, which had incurred such expenditure in the past four years, while Emalahleni did so in the past three years.

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

- Interest on overdue accounts and late payments as well as penalties – R839 million (62%) (2013-14: 85%, R581 million)
- Litigation and claims – R56 million (4%) (2013-14: 1%, R9 million)
- Other (e.g. non-refundable deposits for cancelled events and accommodation) – R449 million (33%) (2013-14: 13%, R91 million).

Of the R1 343 million incurred in 2014-15, an amount of R399 million (30%) was incurred by municipalities in order to avoid further fruitless and wasteful expenditure or losses which often relate to the cost of cancelling irregular contracts or the contracts of non-performers.

As detailed in the section on compliance (section 3.2), 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 148 municipalities (54%) (2013-14: 136 municipalities [50%]) based on the fact that they incurred fruitless and wasteful expenditure in the current as well as previous years, a recurrence of the action that had caused the fruitless and wasteful expenditure, and on our assessment that adequate controls and processes would have prevented it.

Figure 1 further illustrates that we had identified 36% of the fruitless and wasteful expenditure amount during the audit process, which means that some municipalities did not have adequate processes to detect and quantify all fruitless and wasteful expenditure, as required by legislation. This is an improvement since 2010-11 but a regression compared to 2013-14.

3.2.3 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 five years and the proportion thereof that was identified during the audit and not by the auditee. It further reflects the percentage of unauthorised expenditure that relates to non-cash items for the current and previous year.

Figure 1: Five-year trend in unauthorised expenditure

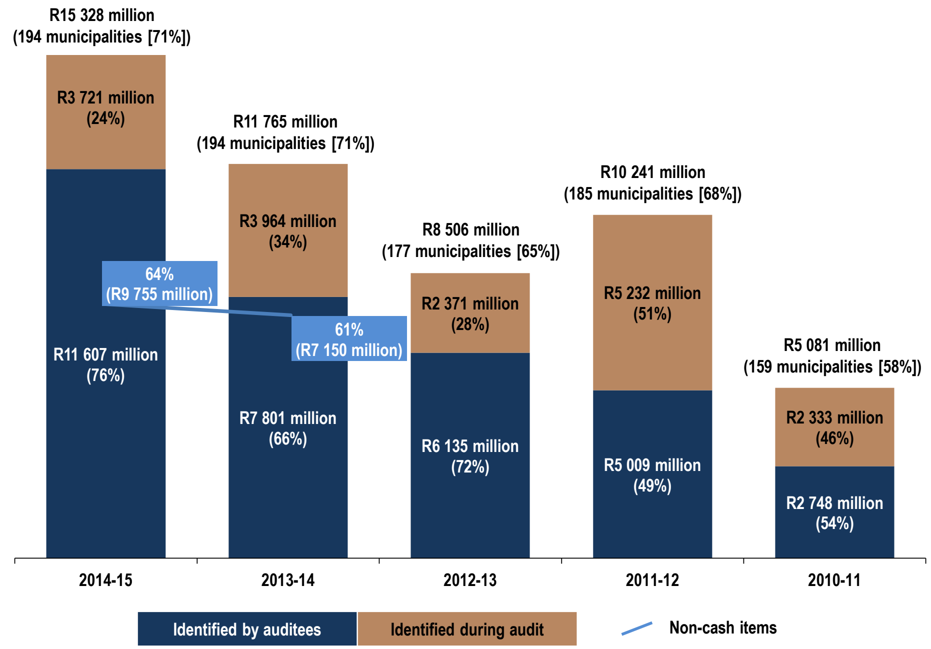


Figure 1 shows that the amount of unauthorised expenditure had increased by 30% since the previous year and more than doubled since 2010-11.

A total of 169 (87%) of the 194 municipalities also incurred unauthorised expenditure in the previous year, 91 of which had incurred such expenditure every year for the past five years. Municipalities in the provinces of Gauteng, North West, Mpumalanga, Eastern Cape and Free State were the main contributors to the significant increase in unauthorised expenditure over the five years.

The following municipalities were the main contributors (32%) to unauthorised expenditure in 2014-15:

- Madibeng (NW): R1 258 million (2013-14: R445 million)
- Mangaung metro (FS): R1 006 million (2013-14: R673 million)
- City of Johannesburg metro (GP): R959 million (2013-14: R0)
- Maluti-A-Phofung (FS): R958 million (2013-14: R434 million)
- City of Tshwane metro (GP): R786 million (2013-14: R1 194 million).

These municipalities are among those that had incurred such expenditure for the past five years, except for Madibeng and City of Johannesburg. Madibeng incurred such expenditure in the past two years, while City of Johannesburg metro incurred such expenditure only in the current year.

Overspending of the budget or main sections within the budget was the reason for 97% (2013-14: 95%; 2010-11: 89%) 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). As per figure 1, 64% of the overspending that had caused the unauthorised expenditure did not represent actual payments in excess of the budget, but rather estimates that had been incorrectly budgeted for. There has been a slight increase compared to 2013-14 when we started analysing the impact of non-cash items.

Three of the main contributors to unauthorised expenditure listed above incurred non-cash-related unauthorised expenditure of over 70% as indicated below:

- City of Johannesburg metro (100%)
- Mangaung metro (81%)
- City of Tshwane metro (72%).

Sixty-four municipalities (24%) incurred unauthorised expenditure of R9 753 million (64%) only because of such non-cash items.

As detailed in section 3.2 on compliance, 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 157 municipalities (58%), based on the fact that they had incurred the same type of unauthorised expenditure in the current and previous years and on our assessment that adequate controls and processes would have prevented it.

Figure 1 shows that we had identified 24% 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 has, however, improved since 2010-11 as well as since the previous year.

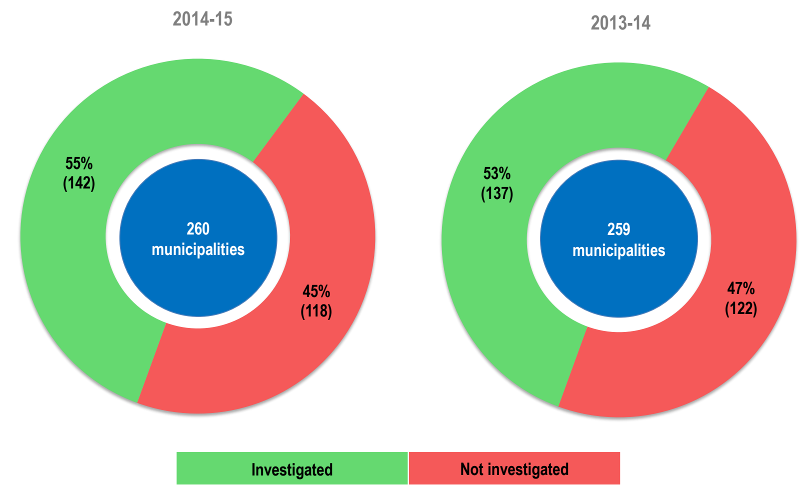
3.2.4 Consequences for transgressions

The MFMA and its regulations clearly stipulate that 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 should be investigated by management.

As detailed in section 3.2, we reported material findings on compliance with legislation in respect of consequence management at 139 (51%) of the municipalities (2013-14: 132 [49%]). In section 3.2.1 to 3.2.3 under **irregular expenditure, fruitless and wasteful expenditure**, and **unauthorised expenditure**, we reported that many municipalities did not meet the requirement that the council should investigate to determine whether any official was liable for the expenditure.

Figure 1 reflects the overall status of council investigations at the municipalities that had incurred these types of expenditure in the prior year.

Figure 1: Investigation of unauthorised, irregular as well as fruitless and wasteful expenditure

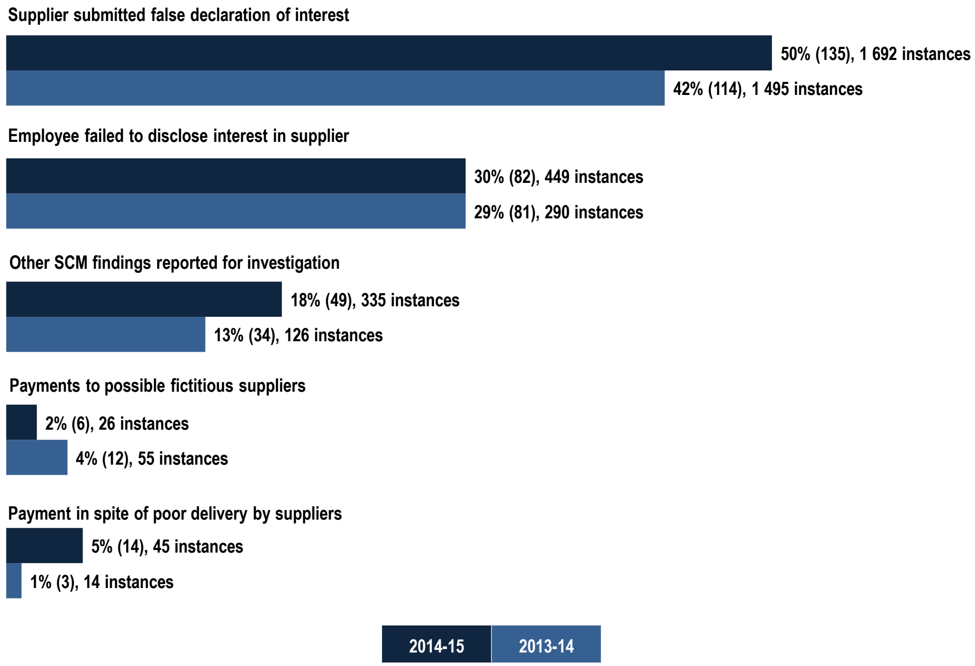


The figure shows that at 45% of the municipalities (2013-14: 47%) the council failed to conduct the required investigations for all instances of unauthorised, irregular and fruitless and wasteful expenditure. Furthermore, 87 of the municipalities that failed to conduct investigations in 2013-14 attracted similar findings in 2014-15.

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. Figure 2 illustrates the extent of SCM findings we had reported to management for investigation.

Figure 2: Supply chain management findings reported to management for investigation



In 2013-14, we reported SCM-related findings for investigation to 139 municipalities. As shown in figure 2, findings in all areas except payments to possible fictitious suppliers have increased. Furthermore, 105 of the municipalities that had such findings in 2013-14 had similar findings in 2014-15.

This means that investigations are not conducted or are not yet having the desired impact of discouraging fraud and improper conduct.

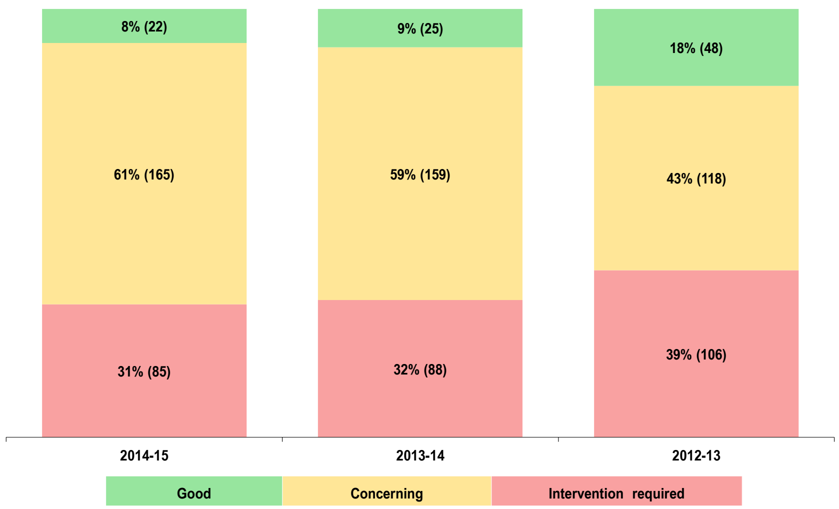
3.3 Financial health

Our audits included a high-level analysis of 12 financial indicators to provide management with an overview of selected aspects of their current financial management and to enable timely remedial action where the municipalities' 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
Concerning	More than two unfavourable indicators
Intervention required	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.

Figure 1 shows our assessment of the financial health of municipalities over the past three years. Although we have reported on financial indicators since 2011-12, the overall assessment approach was only introduced in 2012-13.

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



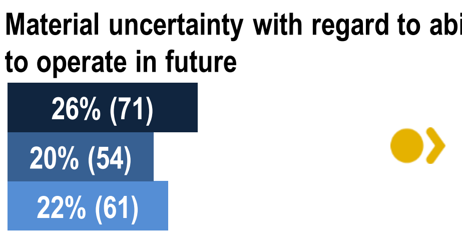
The number of municipalities we assessed as having a good financial health status has decreased since 2012-13, with the main regression in 2013-14 and a slight regression in 2014-15. In 2013-14 municipalities in the Eastern Cape, Free State, KwaZulu-Natal, Mpumalanga, Gauteng, Western Cape and Northern Cape were the main contributors to the regression. This was caused mainly by a lack of proper revenue management practices (e.g. poor debt collection, increase in debtors deemed irrecoverable), which prevented these municipalities from meeting their obligations to creditors, poor budgeting and inadequate cash flow management. The overall regression can in part be attributed to 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 reduction in the number of municipalities in the ‘intervention required’ category since 2012-13 was as a result of a reduction in the number of disclaimed and adverse opinions. Further details are provided of the main financial indicators used for these assessments over the three-year period. The following legend applies to the figures shown:

2014-15	2013-14	2012-13

Figure 2 reflects the number of municipalities which 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 (i.e. as a going concern) or had received a qualified opinion because such disclosures were not included.

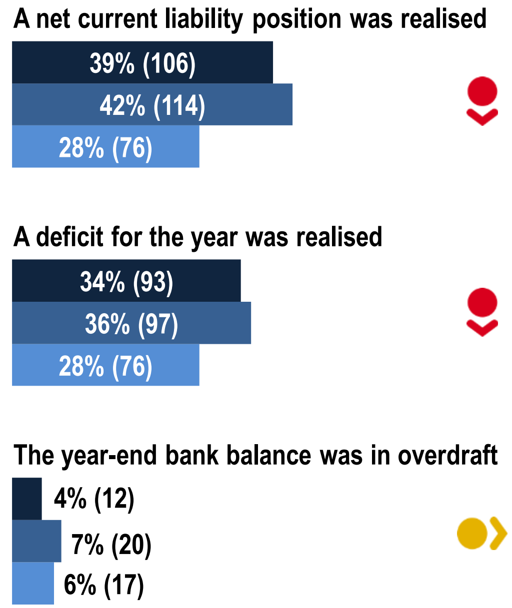
Figure 2: Going concern uncertainty



A going concern uncertainty exists at more than a quarter of the municipalities. There has been a slight increase since 2012-13, with the regression occurring mainly in 2014-15. Municipalities in North West, the Northern Cape, Limpopo, Gauteng and Western Cape were the main contributors to the regression, which was caused by poor debt collection; an improvement from a disclaimer to unqualified or qualified opinions, resulting in financial statements being more reliable for assessing going concern uncertainty; and a lack of effective and efficient revenue generation and debt-collection strategies.

Figure 3 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 3: Sustainability indicators



There has been a significant increase since 2012-13 (most notably in 2013-14) in the number of municipalities that spent more than their available financial resources (resulting in a net deficit) and/or whose current liabilities exceeded their current assets at year-end (net current liability position). There was only a slight improvement on these indicators in 2014-15.

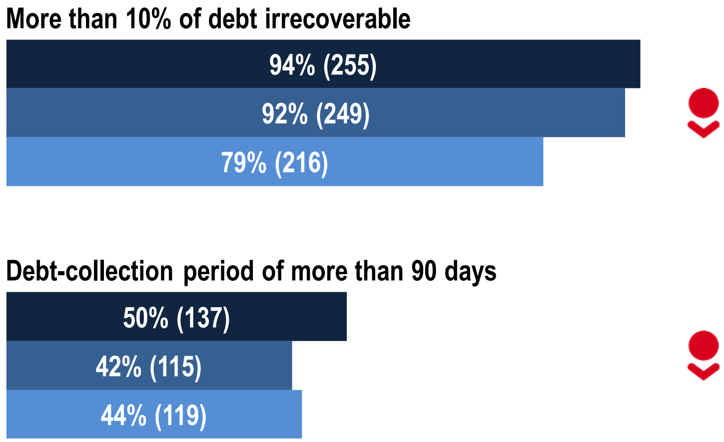
Municipalities in the Northern Cape, Free State Mpumalanga, Gauteng, Limpopo and Eastern Cape were the main contributors to the regression in 2013-14 with regard to net current liability position, which was caused by cash flow problems (mainly due to poor debt collection and inability to pay creditors).

The regression relating to net deficit occurred mainly in 2013-14, with municipalities in the Northern Cape, Eastern Cape, Free State, Limpopo and Mpumalanga being the main contributors. The regression was caused by an increase in non-cash items (e.g. additional recording of depreciations and increase in debtors deemed irrecoverable, resulting in debtors being impaired), poor budgeting processes, over-reliance on grant funding and poor debt-management practices.

The number of municipalities with year-end bank balances in overdraft has decreased slightly since 2012-13.

One of the main reasons for the failing financial health of municipalities is inadequate revenue management. The main indicators over the past three years are reflected in figure 4.

Figure 4: Revenue management

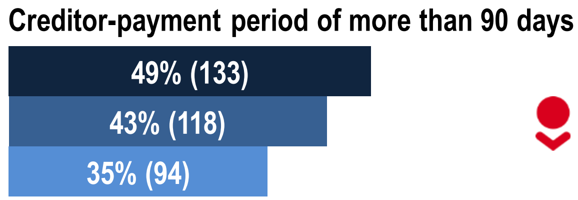


Just over 90% of municipalities estimated in their financial statements that more than 10% of the outstanding amounts owed to them would not be paid, which represents a significant increase over the three-year period. The regression occurred mainly in 2013-14, with municipalities in the Northern Cape, Eastern Cape, KwaZulu-Natal, Gauteng, Limpopo, Mpumalanga and Western Cape being the main contributors. The regression was caused by poor debt-management practices, lack of the right skills in finance units and the poor economic climate.

As part of our analysis, we calculated the average number of days it took for municipalities to collect debt they deemed to be recoverable. Half of the municipalities had an average debt-collection period of over 90 days in 2014-15, with a significant regression in 2014-15. Municipalities in Limpopo, Northern Cape, Free State, Eastern Cape, KwaZulu-Natal and Western Cape were the main contributors to the regression, which was caused by lack of the right skills in finance units, the poor economic climate and inadequate systems that 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 the municipalities under significant pressure, which in turn meant that they took longer to pay their creditors. Figure 5 shows the number of municipalities with an average creditor-payment period of more than 90 days over the three-year period.

Figure 5: Creditor-payment period



The number of municipalities with extended payment periods has increased significantly year on year to almost 50%. The municipalities in Gauteng, Northern Cape, Mpumalanga, Eastern Cape and Free State were the main contributors to the regressions in 2012-13 and 2014-15, which were caused by cash flow problems. The cash flow problems can be attributed in part to poor debt-management practices.

Our analysis of financial health presented here should be evaluated against the backdrop of municipalities being under increasing pressure to provide basic services while financial resources are dwindling. Our analyses over the past three years show a continuing weakening in local government finances as a result of poor collection of revenue from debtors, cash flow problems and the current poor economic climate.

3.4 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, as well as the achievement of planned targets for each allocation.

In this section we present the results of these audit tests for the MSIG, FMG and MIG, as well as overall compliance by municipalities with DoRA. More information on the audit we performed and the purpose of and conditions attached to these grants is included in section 11.

Municipal systems improvement grant and financial management grant

The MSIG and FMG are allocations aimed at capacity building for improving financial and performance management in local government.

For the 272 municipalities reported on in the 2014-15 financial year, R686 million was allocated in terms of DoRA for the MSIG (R247 million) and FMG (R439 million). Due to unspent funds from the previous financial year being rolled over, the 272 municipalities being reported on had R704 million to spend on programmes funded from these grants.

Figures 1 and 2 depict the percentage of grants spent by the municipalities to which they were allocated in 2013-14 and 2014-15. The number (and percentage) of municipalities that received the grants is shown in brackets.

Figure 1: Spending of municipal systems improvement grant

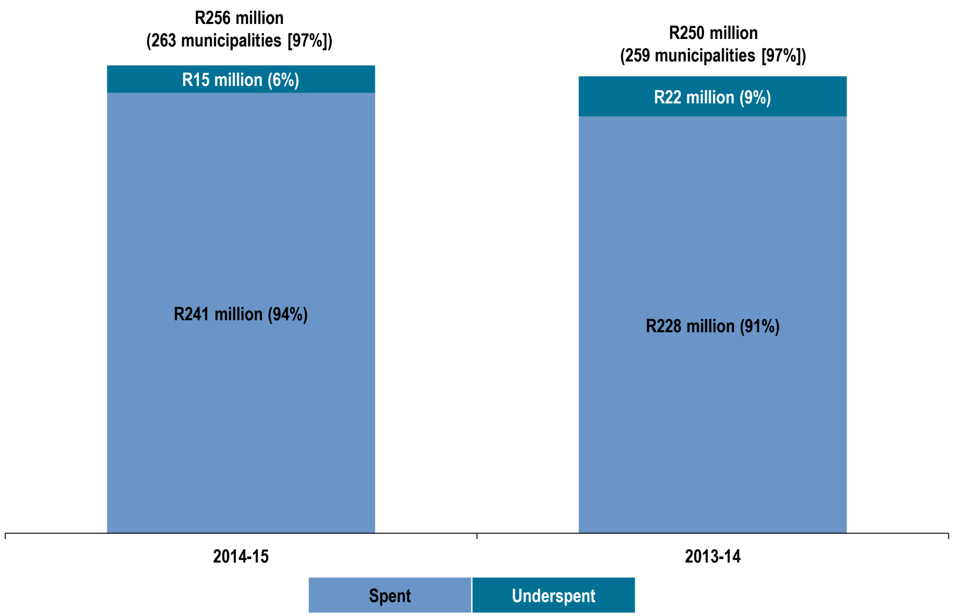
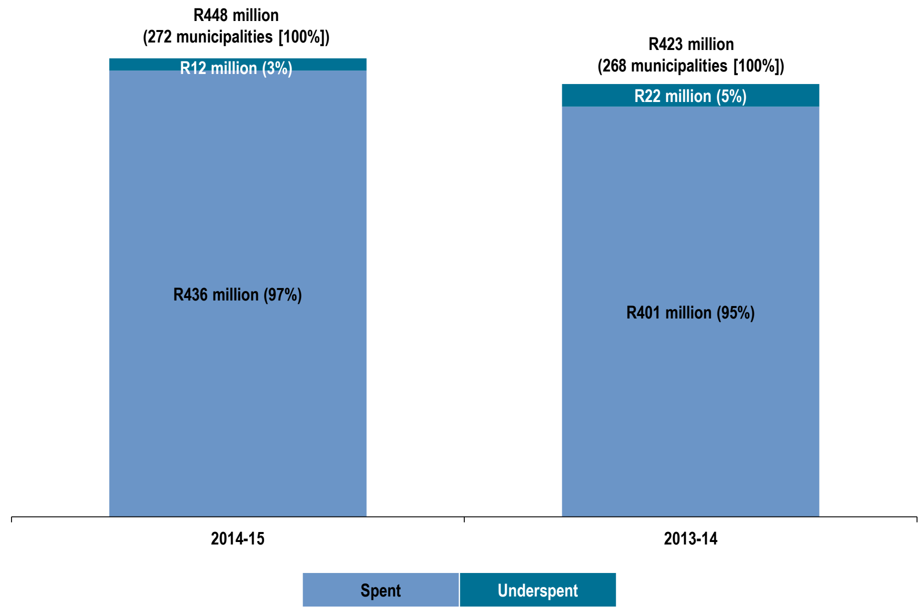


Figure 2: Spending of financial management grant



Both grants show high spending levels at an overall level and a reduction in underspending compared to the previous year. While 66 municipalities underspent on the MSIG, only 36 municipalities underspent by more than 10%. With regard to the FMG, 53 municipalities underspent, but only 21 municipalities underspent by more than 10%. For both these grants this is an improvement since the previous year.

Approximately R53 million (21%) of the MSIG and R83 million (19%) of the FMG were spent on consultants, indicating the extent to which municipalities are using consultants to support financial management and service delivery reforms funded by these grants (also refer to section 5.3 where we discuss the effective management of consultants).

Figures 3 and 4 show the number and percentage of municipalities that received these grants in 2013-14 and 2014-15 and which achieved the targets set for the programmes funded by the grants. The municipalities in the red category are those where either the targets were not achieved or the municipality had not assessed the achievement. The municipalities in the brown category are those where we did not audit the achievement of targets during 2013-14.

Figure 3: Achievement of targets – municipal systems improvement grant

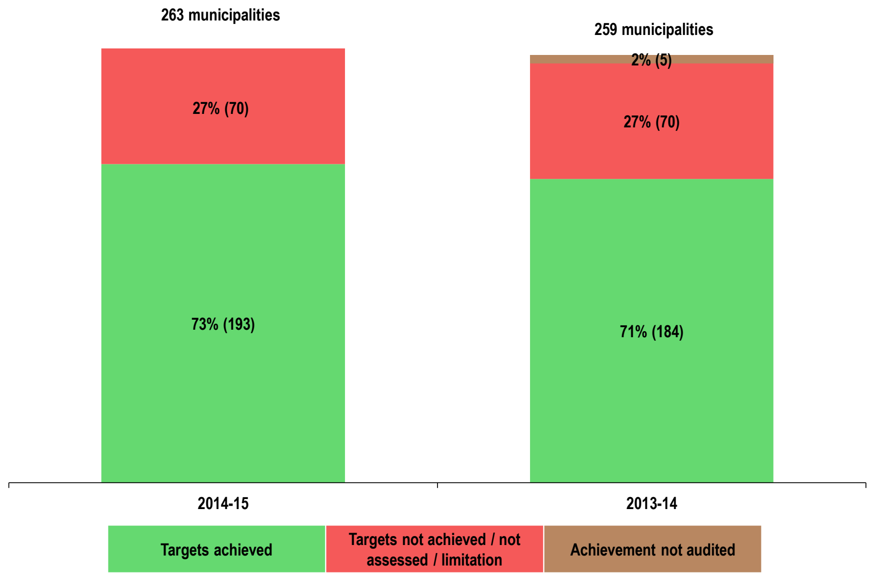
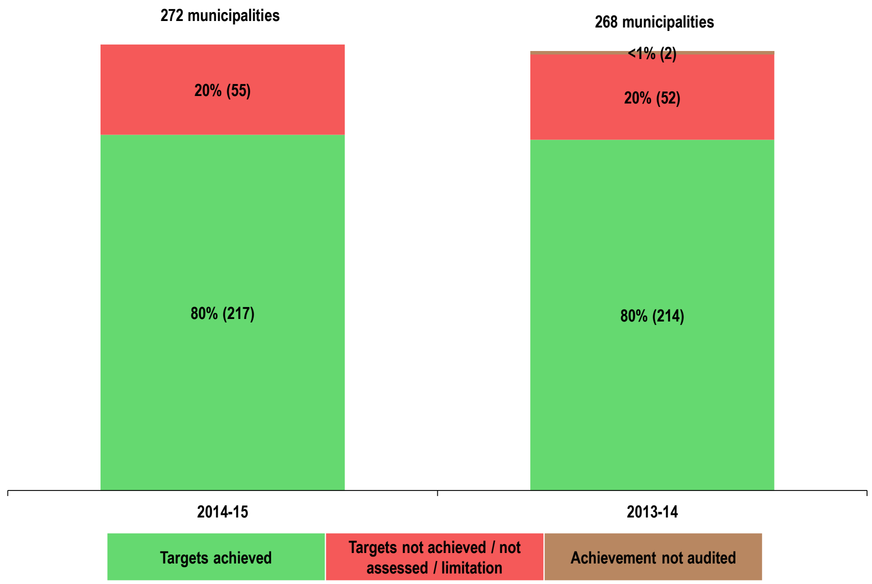


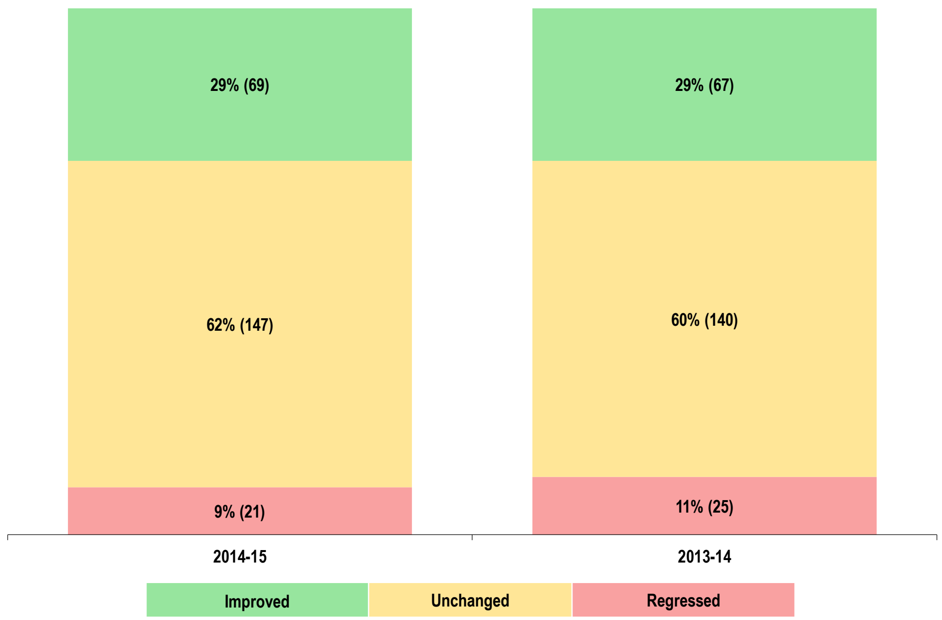
Figure 4: Achievement of targets – financial management grant



The management of the FMG and MSIG by municipalities has remained unchanged since the previous year. Although 94% and 97% of the available funds were spent on the MSIG and FMG, respectively, only 193 municipalities (73%) achieved their MSIG targets and 217 (80%) achieved their FMG targets. Although the municipalities used the money allocated to them, many were still struggling to achieve their targets.

Figure 5 shows whether there had been any change in the audit outcome of the municipalities that received and utilised these grants to improve their financial and performance management (municipalities that have sustained a clean audit status since the previous year are excluded).

Figure 5: Movement in audit outcomes of municipalities funded by the municipal systems improvement grant and/or financial management grant



As indicated above, although conditional grant allocations of R677 million were spent on improving financial and performance management, and the majority of the municipalities were able to achieve the targets set for the programmes, the use of the grant did not have a significant impact on the audit outcomes. The most common reasons for this were the following:

- Some outputs or targets of these allocations were not directly linked to improving financial management or audit outcomes.
- A lack of ownership by management resulted in slow progress being made to honour commitments and address key control weaknesses aimed at improving financial management.
- A number of municipalities in this category used consultants for financial reporting. Due to the late appointment of consultants and/or weaknesses in managing them, they were often unable to improve the audit outcomes.
- Some municipalities in the 'unchanged' or 'regressed' categories spent a portion of the allocation on training. However, the impact of the training may only be realised over time, or not at all if officials do not apply the newly acquired knowledge in their jobs.
- Grant funding was used for other purposes due to weak cash flow management at some municipalities.

Efforts must be increased to ensure that there is a correlation between the spending of grants, the achievement of targets, and the desired impact of the grants.

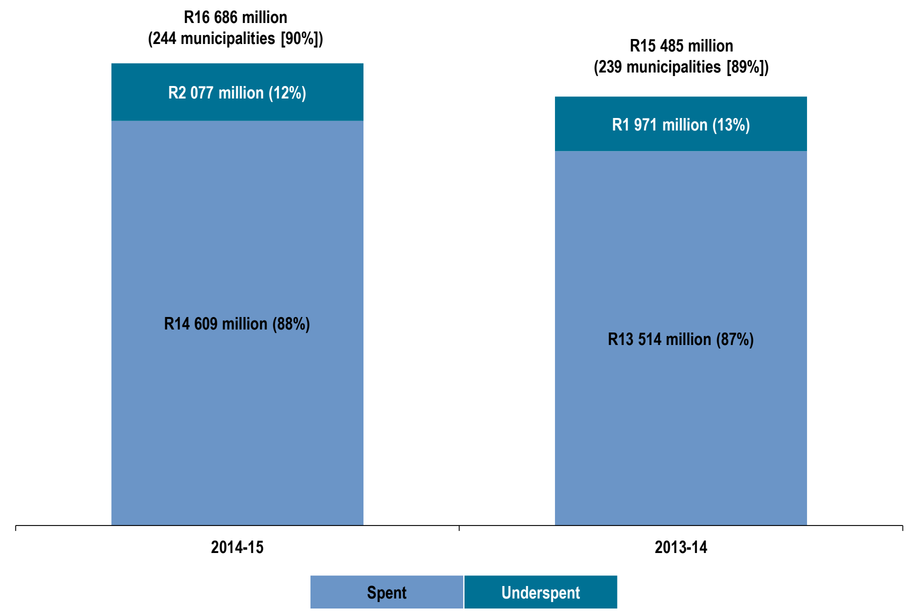
Municipal infrastructure grant

CoGTA introduced the MIG in 2004-05 with the core outcome to improve access to basic service infrastructure for poor communities by providing specific capital finance for basic municipal infrastructure backlogs.

For the 2014-15 financial year, R14,6 billion was allocated in terms of DoRA for the MIG. Due to unspent funds rolled over from the previous financial year, the 244 municipalities being reported on had R16,7 billion to spend on infrastructure projects funded from the MIG.

Figure 6 shows the percentage of the MIG spent by the municipalities to which it was allocated in 2013-14 and 2014-15.

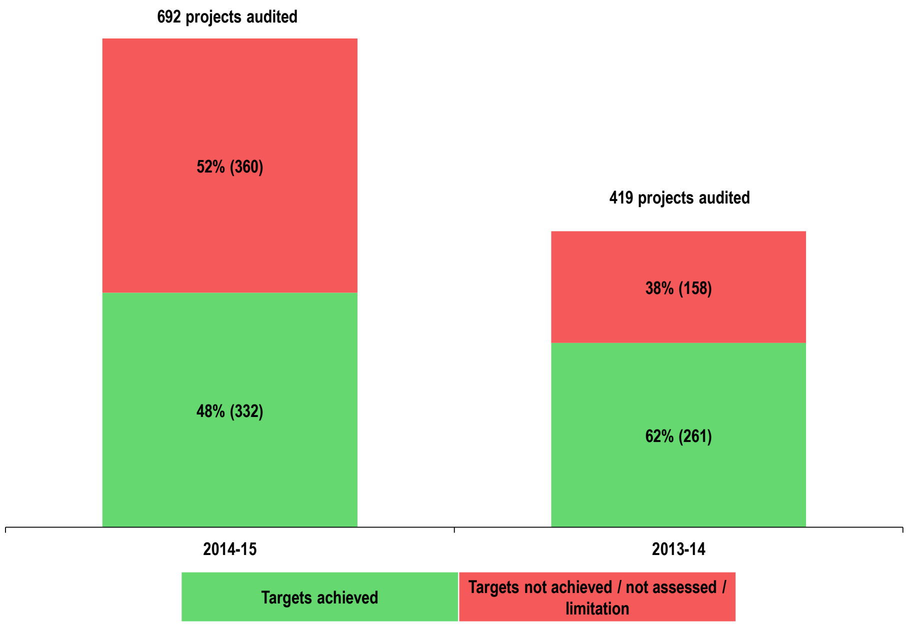
Figure 6: Spending of municipal infrastructure grant



Of the available R16,7 billion, R14,6 billion was spent – which translates into a reasonable level of spending, namely 88%, the same level as in 2013-14. In total, 131 municipalities underspent on the MIG, of which 82 underspent by more than 10%. This is an improvement compared to the 95 municipalities in 2013-14.

We tested the reported performance against planned targets for specific projects funded by the MIG at the 244 municipalities that received the grants. Figure 7 depicts the achievement of planned targets for the infrastructure projects we audited in 2013-14 and 2014-15. The projects in the red category are those where the targets were not achieved or the municipality had not assessed the achievement or we could not audit the assessment as supporting documentation could not be provided.

Figure 7: Targets achieved – projects audited



In 2014-15 we increased the number of MIG-funded projects we audited in order to have a more comprehensive picture of delivery on these projects.

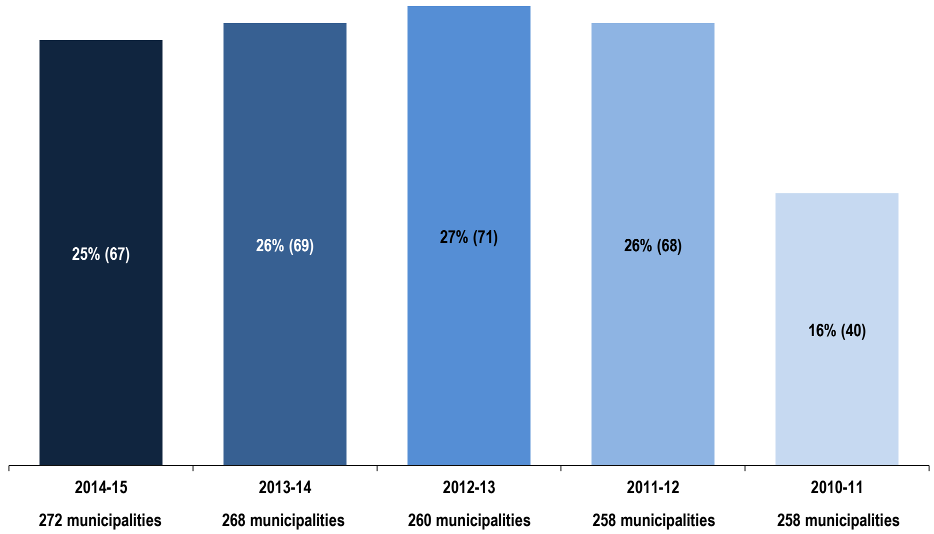
We continued to audit the multi-year projects selected in 2013-14 and selected additional projects with a bias towards those that deliver water and sanitation infrastructure. As a result of the increase in the number of projects tested and the change in focus, figure 7 shows a regression. This cannot necessarily be construed as a regression in the ability of municipalities to manage their infrastructure projects. Rather, our audit of infrastructure projects in 2014-15 now presents a more realistic picture of the challenges of managing infrastructure projects in local government.

The slow delivery of these projects affects the ability of municipalities to improve access to basic services for poor communities.

Non-compliance with Division of Revenue Act

Figure 8 shows the number of municipalities since 2011-12 that received any conditional grant via a DoRA allocation where we reported material findings on compliance with the act.

Figure 8: Non-compliance with DoRA in managing conditional grants over five years



Sixty-seven of the 272 municipalities that received conditional grants via a DoRA allocation failed materially to comply with the act, as depicted in figure 8. This high incidence of non-compliance has been the norm for the past five years, having peaked in 2012-13.

The following most common compliance findings in 2014-15 indicate that the funds provided through grants and the programmes funded are not well managed at all municipalities:

- The performance of the programmes funded with allocations was not evaluated – 46 municipalities (2013-14: 51; 2010-11: 23)
- Allocations were used for purposes other than those stipulated in DoRA or in the gazetted framework – 26 municipalities (2013-14: 27; 2010-11: 24)
- The unspent portion of the conditional grant was retained at year-end without the approval of the National Treasury – 17 municipalities (2013-14: 13; 2010-11: 1).

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

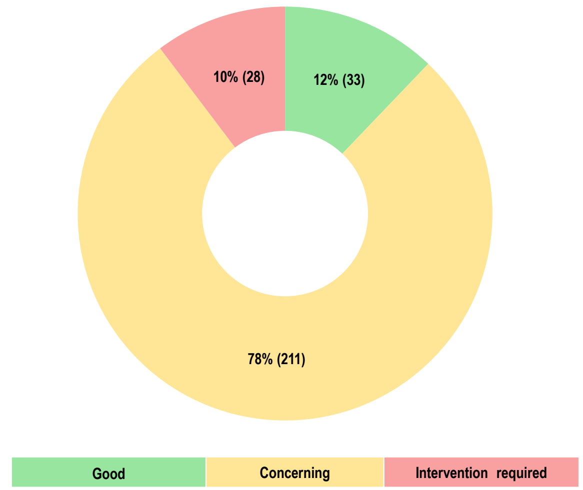
3.5 mSCOA readiness

The Municipal Regulations on Standard Chart of Accounts (mSCOA) were gazetted on 22 April 2014, which established the application of mSCOA in local government as a legislated requirement. The mSCOA will take effect on 1 July 2017 and will thus impact the 2017-18 financial statements and audits of all local government municipalities. The piloting of mSCOA has already commenced at 19 local municipalities, two district municipalities and eight metros, phased in over the 2015-16 and 2016-17 financial years. Piloting takes place in close cooperation with the National Treasury's mSCOA project team and provincial treasuries. The key objectives of the mSCOA project are as follows:

- Development of uniform data sets critical for 'whole-of-government' reporting, enabling deeper data analysis and sector comparisons to improve financial performance
- Standardisation and alignment of the 'local government accountability cycle' by regulating not only the budget and in-year reporting formats but also the annual report and annual financial statement formats
- Improved transparency, accountability and governance through uniform recording of transactions at posting account level detail
- The standardisation of 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 the state of readiness of municipalities for implementation of the new mSCOA as assessed by us. It shows the number of municipalities where readiness/preparation is good, concerning or requires intervention. The pilot municipalities that were not assessed as good were Berg River, Drakenstein and Knysna (Western Cape), Nelson Mandela Bay metro, Buffalo City metro, Camdeboo and Senqu (Eastern Cape), Richmond (KwaZulu-Natal) and Tlokwe (North West).

Figure 1: Readiness for mSCOA



Municipalities have been aware of the mSCOA requirements since 22 April 2014, but have generally made slow progress in ensuring that they would be ready to implement mSCOA by the due date. Based on the mSCOA readiness assessment performed, the readiness of 78% of municipalities is concerning, while that of 10% requires intervention, which represents the majority of municipalities.

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

- Municipalities experienced capacity and skills constraints in planning and managing the change to mSCOA requirements
- Municipalities did not have the money to start implementing the mSCOA and to make use of the internal audit unit to support them from a project assurance perspective
- Municipalities were waiting for the outcomes of the pilot municipalities that were in the process of implementing the mSCOA to ensure that they address the lessons learned from these pilots.

Although the above-mentioned root causes were identified, it is imperative that all municipalities should immediately prioritise the successful implementation of mSCOA to ensure local government succeeds in their common goal to meet the key objectives by 1 July 2017.

3.6 Status of electronic fund transfer controls

We assessed electronic fund transfer (EFT) controls at 144 municipalities which had more complex IT environments and required the assistance of an IT audit expert. The objective of EFT controls is to ensure that electronic payments made to suppliers and others are confidential, secure and completely and accurately recorded and properly authorised.

Figure 1 indicates that EFT controls are inadequate at most of the municipalities where controls were assessed.

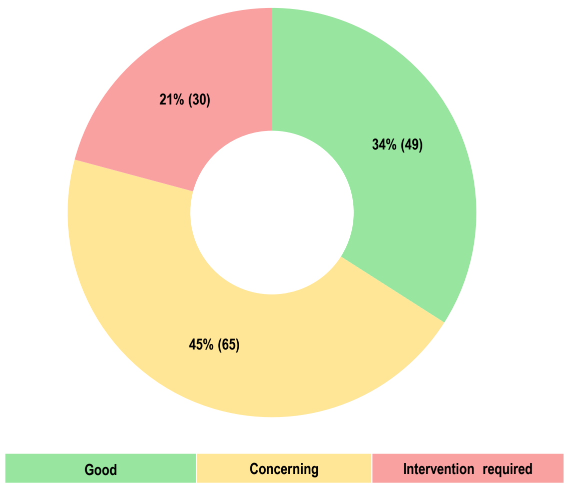
The most common findings on EFT controls were as follows:

- Users performed inadequate monitoring and review of activities on the EFT system
- User access was not reviewed and revoked when users left the municipality
- Lack of segregation of duties and lack of management of approval limits to release payments.

The risks associated with poor EFT controls are as follows:

- Errors in EFT systems going undetected
- Loss of confidentiality due to other parties acquiring sensitive information
- Fraud due to changes to computer records and manipulation of data.

Figure 1: Status of electronic fund transfers



3.7 Conclusion

As stated in the back-to-basics approach and supported by the MTSF, local government should demonstrate sound financial management and accounting practices and prudently manage resources to sustainably deliver services and bring development to communities.

In the past five years there has been improvement in the financial management and administration of local government, but progress is slow and critical shortcomings remain.

An increasing number of municipalities now accurately and transparently account, through their annual financial statements, for the use of public funds, the financial state of their municipality and the extent of unauthorised, irregular as well as fruitless and wasteful expenditure incurred.

The poor quality of financial statements submitted to us for audit and the continuing reliance on consultants for financial reporting services call into question whether the in-year reporting and management of finances by municipalities are solid. The signs of poor financial management are apparent in the budget preparation and monitoring processes (resulting in unauthorised expenditure), revenue management, payment of creditors, control over EFT payments, grant management and general financial viability of municipalities, which continue to weaken year on year.

We are concerned that municipalities are not adequately preparing for the mSCOA reform. The gains made in improved accounting through credible financial statements could be lost if left unattended.

Municipalities are under increasing pressure to provide basic services, while financial resources are dwindling. This requires prudent management of resources and strong control over procurement processes and delivery by service providers. In the past five years there has been little improvement in the municipalities' SCM practices and expenditure management, resulting in increasing levels of irregular expenditure, fruitless and wasteful expenditure and lost opportunities to save costs and ensure value for the money.

Several municipalities across the country, from metros to small municipalities in rural areas, have demonstrated sound financial management and accounting practices and prudent management of resources and serve as an example of good governance and accountability for the rest of local government to follow.