

# // SECTION 3



*Material irregularities*

## INTRODUCING MATERIAL IRREGULARITIES

The **responsibilities and duties of municipal managers are well defined** in the Municipal Finance Management Act, which are all underpinned by the basic values and principles governing public administration as set out in our country's constitution. It includes the need for high standards of professional ethics, accountability and transparency as well as the promotion of the efficient, economical and effective use of resources.

Our audits have for many years been highlighting a systemic failure in local government to establish the systems, processes and controls required to make the constitutional principles and the requirements of the Municipal Finance Management Act the norm. Not only are **irregularities and the resultant**

**losses, misuse and harm not prevented from happening, it is also not appropriately dealt with when it is identified.** This is evident in the rising irregular expenditure not being dealt with, the lack of action on potential fraud and corruption, and the continued disregard for our findings and recommendations.

The remarks made by Chief Justice Mogoeng Mogoeng in October 2016 at a meeting of the heads of supreme audit institutions were a catalyst for the **changes made to our mandate** through the amendments to the Public Audit Act. The amendments were driven by the Standing Committee on the Auditor-General and received unprecedented support in Parliament.



**'...the failure to be disciplined in the way you use public resources, would not only attract consequences, but serious consequences...'**

Call it 'the power to follow up on audit recommendations, the power to take remedial action, the power to ensure compliance', but you need to strengthen the pre-existing mechanism to follow up on the recommendations he made. Only then, I would believe, would qualified audit reports come down significantly. When people know that failure to act in line with the legal framework applicable to the use of public money, and the failure to be disciplined in the way you use public resources, would not only attract consequences, but serious consequences... [would audit outcomes improve].

[Audit follow-ups] should not be a loose arrangement dependent on the mercy or reasonableness of the incumbent affected by a negative audit report. People should know in advance that it is a matter of compliance with the Constitution, it is a matter of compliance with a statute, and there are serious consequences if you don't do it. In that way I believe they would be incentivised to do much more than they would otherwise have done absent that provision.

*Chief Justice Mogoeng Mogoeng, CBC meeting – October 2016*

## The amendments provide us with an expanded mandate to:



**Refer material irregularities** to relevant public bodies for further investigations



**Take binding remedial action** for failure to implement our recommendations for material irregularities



**Issue a certificate of debt** for failure to implement the remedial action if financial loss was involved

The amendments to the Public Audit Act became effective on 1 April 2019. These amendments introduced the concept of a material irregularity.

## What is a material irregularity?

Irregularity

**Material irregularity**

Impact

Any **non-compliance with**, or contravention of, **legislation, fraud, theft or a breach of a fiduciary duty**

identified during an audit performed under the Public Audit Act that **resulted in or is likely to result in ...**

a **material financial loss**, the **misuse or loss of a material public resource** or **substantial harm to a public sector institution or the general public**.

Municipal managers are familiar with the different elements of a material irregularity, as they are responsible for **preventing irregularities** such as non-compliance, fraud, theft and breaches of fiduciary duty and the impact in terms of the loss or misuse of the money and resources financed by taxpayers. They also have a clear duty to serve and protect the community and the well-being of the municipality they are leading.

The intent of the amendments is **not to take over the functions of the municipal managers**, as their accountability responsibilities are clear in legislation. It was also not an attempt to bring another punitive measure but rather a **complementary mechanism for strengthening financial and performance management**, which in turn will contribute to improved accountability in the public sector. Hence, our extended powers will only be activated if we reported a material irregularity to a municipal manager and they did not take appropriate and timely action to address it.

By identifying material irregularities, we **support municipal managers** by bringing to their attention

the irregularities that could have a significant impact on finances, resources and service delivery while also empowering them to timeously take the appropriate steps in terms of legislation. This will lessen the adverse effect of such irregularities on municipalities, set the right tone for accountability, highlight the need for consequences, and encourage a behavioural change at the highest levels. We report the material irregularities in the audit report, which also **enables councils and the municipal public accounts committees to perform their oversight function** – focusing on the most material matters affecting municipalities.

If municipal managers, supported by their political leadership, adhere to their legislated responsibilities and commit to take swift action when we notify them of a material irregularity, there will be **no need for us to use our remedial and referral powers**.

They should focus on **preventing material irregularities**, as it is more effective than having to deal with the impact and consequences thereof. More insights on the prevention of material irregularities are included at the end of this section.



## THE DIFFERENCE BETWEEN MATERIAL IRREGULARITIES AND IRREGULAR EXPENDITURE

A material irregularity and irregular expenditure are not the same, as shown below:

### Irregular expenditure

Irregular expenditure is all expenditure where there was non-compliance with legislation in the process leading up to the payment.

For example, if the procurement process for the awarding of a construction contract did not comply with legislation on supply chain management, all payments to that contractor will be irregular expenditure.

When irregular expenditure is identified, the municipal manager is required to perform an investigation to determine the impact by considering if the non-compliance resulted in a financial loss, whether there was any fraud involved, and if an official should be held accountable. If there was no loss or fraud, the irregular expenditure will be condoned after the necessary disciplinary action had been taken.

### Material irregularity

As with irregular expenditure, a material irregularity also stems from non-compliance with legislation, but it has a broader scope and can be applied to fraud and theft and to a breach of fiduciary duty (which means that an official did not do what the legislation requires and/or did not act in the best interest of the municipality).

Another key difference is that for any non-compliance to be considered a material irregularity, there must already be an indication that the non-compliance resulted in, or is likely to have a material impact in the form of, a material financial loss, the misuse or loss of a material public resource, or substantial harm to a public sector institution or the general public.

**The values will differ.** Irregular expenditure is the total expenditure. If the material irregularity relates to a financial loss, the value will be the loss. A material irregularity will also not always have a value (for example, substantial harm cannot be quantified).

### Example

A lack of a competitive bidding process for the awarding of a contract of R20 million.

The irregular expenditure is all the payments made on the contract to date (e.g. R10 million).

### Example

A lack of a competitive bidding process for the awarding of a contract of R20 million resulting in a material financial loss, as the same service could have been delivered at a lower price (e.g. R18 million).

The financial loss is R2 million (what was lost and what can still be lost).

## APPROACH TO 2018-19 AUDITS

Irregularities are **identified during our normal audit process** as we audit compliance with key legislation as well as consider governance and control as part of the audit. Our audit processes can also identify possible fraud and theft, which we then report to management for investigation.

However, our audit process **generally does not consider the impact** of the irregularities identified (for example, if a financial loss is likely), as it is not required by the auditing standards. The requirements and processes to follow for a material irregularity as prescribed by the Public Audit Act and the Material Irregularity Regulations introduce additional steps in the audit process, new processes for referrals and remedial action, and the establishment of new structures and additional capacity.

The impact of the expanded mandate on our audit process and organisation as well as the profound implications thereof requires us to **implement the changes in a careful, but progressive manner**. As agreed with the Standing Committee on the Auditor-General, we are phasing in the implementation of our expanded mandate.

The phasing-in allows us to:

- responsibly align the organisational resources with the demand placed on us by the Public Audit Act
- establish relationships with the public bodies to which we will be referring material irregularities
- create the required level of awareness of the Public Audit Act and the Material Irregularity Regulations in the external environment.

For the 2018-19 audits, **we implemented the material irregularity process at a limited number of municipalities** (nine), which we selected based on their audit outcomes and their history of irregular expenditure.

In the first phase of implementation, we focused on identifying material irregularities that relate to **non-compliance that can result in a material financial loss** identified as part of our compliance audit. The reason for this focus is that we already have well-established processes to identify material non-compliance with key legislation and that the recovery of financial losses is of great concern to the country. We will continue with a phased approach over the next few years but will progressively increase the extent of the work we do until it is fully implemented at all municipalities and municipal entities.

### WHAT DID WE DO TO IDENTIFY MATERIAL IRREGULARITIES?

The material irregularity process was applied only from 1 April 2019 at the selected municipalities, when the amendments became effective. The auditor-general used the discretion allowed by the Public Audit Act to direct that the audit teams **only consider material irregularities where it continued to have a financial impact in the 2018-19 financial year**. This means that we did not consider non-compliance that took place in prior years except where it continued to financially affect the municipality; for example, if payments are still being made on a contract that was irregularly awarded in prior years, or if a debt owed to the municipality was still in its books in 2018-19.

We also made sure that we applied the definition of a material irregularity correctly by only reporting it if the **non-compliance directly resulted in a financial loss** or there were sufficient indicators that it is likely to result in a financial loss. We considered whether **a financial loss was material** through considering its value, nature and impact. The value of the financial

loss had often already been determined by the municipality and disclosed in the financial statements, such as fruitless and wasteful expenditure (what we refer to as a known financial loss). But for some material irregularities, we estimated the potential financial loss to consider if it was material (what we refer to as an estimated financial loss).

The limited time available for finalising the audit, the complexity of some of the matters we dealt with, the difficulties experienced at some of the municipalities to perform the audits, and the time we gave municipal managers to respond to identified material irregularities **affected our ability to finalise most of the audits by 30 November 2019 (or 31 December for the metros)**. We could also not complete the process of notifying municipal managers and assessing their responses to the notification at some of the municipalities before finalising the audit. It is likely that **additional material irregularities will be reported** at the selected municipalities in upcoming audits.



## WHAT DID WE DO WHEN WE IDENTIFIED A MATERIAL IRREGULARITY?

When we identified a material irregularity, the municipal manager **was notified** without delay. We gave them 20 working days to respond to the notification by giving us a written submission and evidence on what they have done to address the material irregularity and what their further planned actions are.

**We assessed the responses** provided and concluded whether their actions (taken or planned) and the outcomes thereof were appropriate in line with their legal obligations. If we found the actions and outcomes to be appropriate, we took no further action and **reported the material irregularity and the taken and planned actions of the municipal manager in the audit report**. This was the case for all the material irregularities identified in 2018-19.

Where we notified municipal managers of a material irregularity but could not finalise the process of receiving and assessing their response before finalising the audit, we reported in the audit report that an **'other' material irregularity** was identified but all the processes had not been finalised by the time of the audit report.

If we would have concluded that appropriate actions had not been taken, the normal process would be to include **recommendations in the audit report** on what the municipal manager should do to address the material irregularity, with a deadline by when these recommendations should be implemented. Alternatively, we would have **referred the material irregularity to a public body for further investigation**.



## LEGAL OBLIGATIONS OF MUNICIPAL MANAGER TO ADDRESS AN IRREGULARITY

If a municipal manager is made aware of an irregularity (non-compliance, fraud, theft or a breach of fiduciary duty), the **Municipal Finance Management Act and its regulations typically prescribe** the following steps to be taken:

1. Perform a preliminary investigation to determine the facts and collect information on what caused the transgression, who is responsible, and whether a financial loss was (or will be) suffered

### If applicable

2. Prevent any losses or further losses
3. Institute a formal investigation if there are indications of fraud, corruption or other criminal conduct; if confirmed, take further action (e.g. report the matter to the South African Police Service)
4. Recover any financial losses from an external party
5. Take steps against the responsible official/s (which can include a financial misconduct investigation)
6. Recover any financial losses from the responsible official/s

The **policies and procedures** of a municipality typically describe how these steps should be taken and the timing thereof.

## WHAT HAPPENS WITH THE IDENTIFIED MATERIAL IRREGULARITIES?

A material irregularity is only **fully resolved** if (1) the loss (or further losses) is prevented and/or any losses incurred have been recovered or all possible steps have been taken to recover the losses; and (2) appropriate steps have been taken against the person or party responsible for the loss.

The **responsibilities for the further steps** to be taken by the municipal manager, mayor and council (including the municipal public accounts committee) to resolve the material irregularities identified in 2018-19 are detailed as follows.



**Municipal manager is dealing with the material irregularity**

### Auditor-General of South Africa and municipal manager

**Municipal manager** implements the committed actions to address the material irregularity and improves controls to prevent recurrence

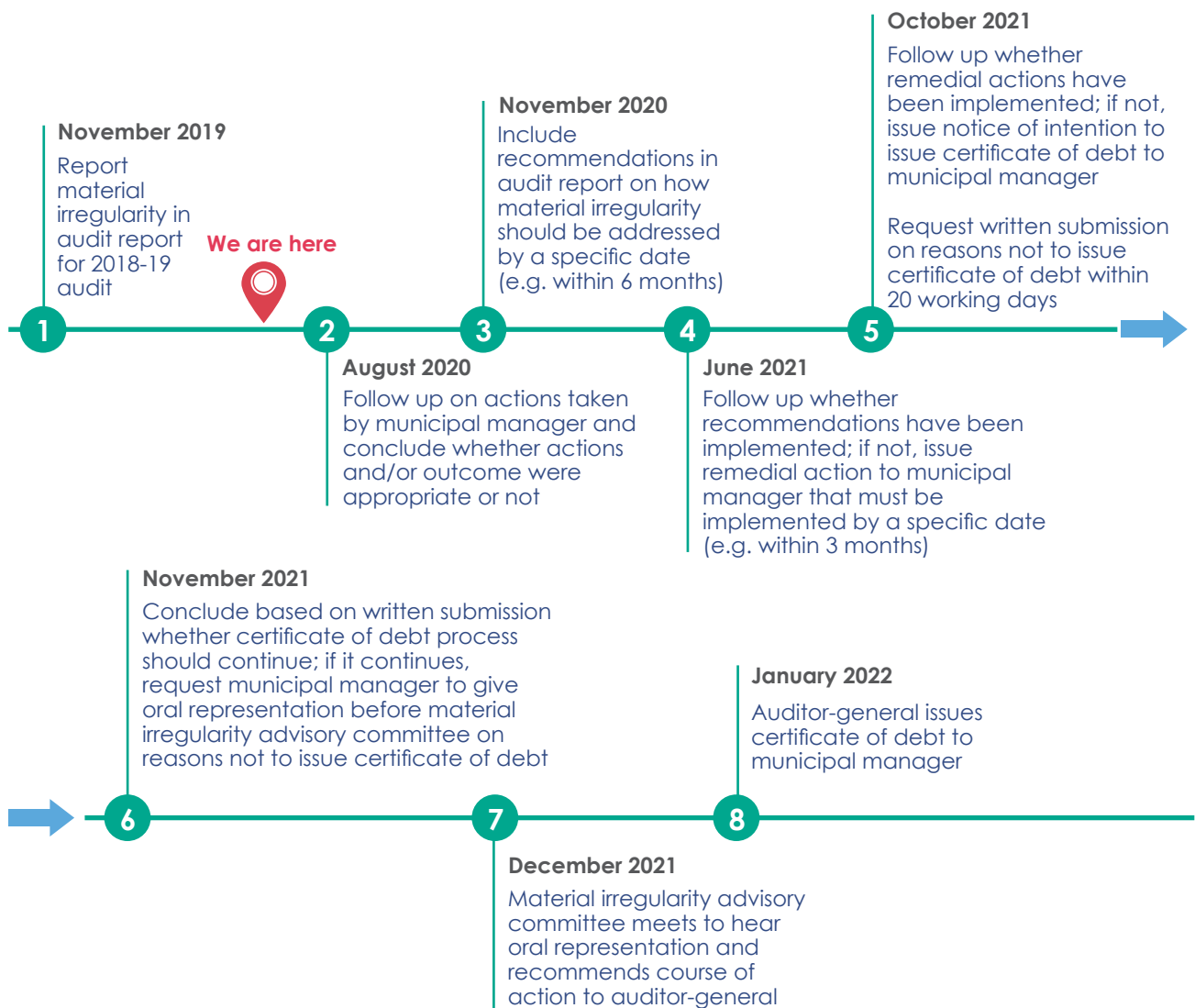
**Auditor-General of South Africa** follows up in the next audit if actions were implemented and if outcomes were reasonable – if not, can result in referral or a recommendation in the audit report

### Mayor and council

**Mayor** monitors progress and supports municipal manager in addressing the material irregularity and improving controls

**Council** monitors progress and calls municipal manager to account for actions taken and outcomes

If the follow-up in the next audit results in a recommendation in the 2019-20 audit report for the municipal manager to implement specific actions to resolve the material irregularity, it can result in a certificate of debt for the municipal manager by January 2022 as illustrated below.



The material irregularities and the progress made in resolving them will be **reported in the audit report of the municipality and in general reports until they have been fully resolved** to enable accountability and oversight.



## OUTCOMES FROM THE 2018-19 AUDITS

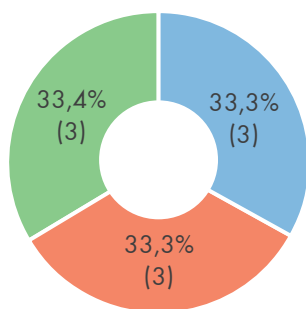
Nine municipalities were identified for implementation of the material irregularity process in 2018-19. The **overall outcomes** were as follows:

**6** material irregularities reported

**R24 499 866** financial loss

(**R2 421 897** known and  
**R22 077 969** estimated)

**3 (100%)** municipal managers are taking appropriate action to resolve material irregularities



Completed audits – no material irregularities identified

Completed audits – material irregularities identified

Audits outstanding at 31 March 2020

Municipalities identified in phase 1	Status	Material irregularities reported
Ngaka Modiri Molema District (NW)	Completed audits – material irregularities identified	3
City of Tshwane Metro (GP)	Completed audits – material irregularities identified	2
Ga-Segonyana (NC)	Completed audits – material irregularities identified	1
Nelson Mandela Bay Metro (EC)	Completed audits – no material irregularities identified	0*
eThekweni Metro (KZN)	Completed audits – no material irregularities identified	0
City of Cape Town Metro (WC)	Completed audits – no material irregularities identified	0
Matjhabeng (FS)	Audits outstanding at 31 March 2020	
Mogalakwena (LP)	Audits outstanding at 31 March 2020	
Dr JS Moroka (MP)	Audits outstanding at 31 March 2020	

\* Material irregularities were identified but reported as an 'other' material irregularity in the audit report, as all processes had not been finalised by the time of the audit report

### Nature of material irregularities





## SUMMARY OF MATERIAL IRREGULARITIES IDENTIFIED AND REPORTED IN THE AUDIT REPORTS

Municipality	Number of material irregularities	Description	Financial loss	Action being taken by municipal manager
Ngaka Modiri Molema District	3	A failure by the municipality to monitor a contract for construction work to the municipal office building and gate house resulted in a contract extension that included items which had already been paid for as part of the original contract – this resulted in costs that could have been avoided.	To be quantified by municipal manager based on investigation	The municipal manager plans to request access to a report from an investigation commissioned by the provincial treasury on the awarding of the contract and extension to the contractor. If the report is not provided, an independent investigation will be commissioned by the municipal manager by 15 June 2020. Further steps will be taken based on the outcome of the investigation.
		The claims from a supplier of water tankering services were paid without ensuring that the services had actually been rendered and that the claims were based on actual kilometres travelled – this resulted in an overpayment to the supplier.	To be quantified by municipal manager based on investigation	The municipal manager will appoint an independent party in February 2020 to investigate the claims and quantify the financial loss. Further steps will be taken based on the outcome of the investigation.
		Poor safeguarding of assets resulted in a material write-off of assets that could not be located during the year-end asset verification process. The assets are presumed to have been stolen.	R2 421 897	The municipal manager plans a full asset verification process and investigation into the missing assets by 31 March 2020. Further steps will be taken based on the outcome of the investigation by 30 April 2020.
City of Tshwane Metro	2	The municipality did not take all reasonable steps to safeguard the assets at the Annlin reservoir project, resulting in assets being stolen and vandalised on 8 January 2018.	R5 523 136	The municipal manager reported the matter to the South African Police Service and commissioned an investigation by the internal forensic services division to be completed by 30 June 2020. Steps were taken to improve security at the site and a security company is planned to be appointed by 31 March 2020 in order to prevent further losses.



Municipality	Number of material irregularities	Description	Financial loss	Action being taken by municipal manager
City of Tshwane Metro		The municipality did not take all reasonable steps to safeguard the assets at the Baviaanspoort wastewater treatment works, resulting in assets being stolen and vandalised on 10 February 2016.	R3 904 346	The municipal manager reported the matter to the South African Police Service and arrests were made. An investigation by the internal forensic services division was commissioned to be completed by 30 June 2020. Steps were taken to improve security at the site and a security company is planned to be appointed by 31 March 2020 in order to prevent further losses. An insurance company reimbursed R174 716 of the loss.
Ga-Segonyana	1	A contract was awarded on 8 February 2019 to a supplier of protective clothing without following a competitive bidding process. The basis for deviation was impracticality, which was not a valid reason. The prices of the goods were significantly higher than market prices.	To be quantified by municipal manager based on investigation	The municipal manager instituted an investigation into the matter on 3 March 2020. Based on the outcome of the investigation, disciplinary steps will be taken and the financial losses recovered.

Based on the outcomes of the 2018-19 audits, we can make the following **observations**:

- All affected municipal managers are taking appropriate action to address the material irregularities identified. They had already started taking action in some cases by the time we formally notified them of the material irregularity. This demonstrates that municipal managers understand what they are required by legislation to do when they become aware of irregularities and that they are willing and able to take on these responsibilities. It also signals a behavioural change towards responding in a decisive and timely manner to our findings.
- Most of the material irregularities identified were money lost as a result of payments that should not have been made or projects and assets not being safeguarded as required. These material irregularities are not complex issues and could have been prevented through basic controls. The material irregularities resulting from supply chain management non-compliance were also mostly not complex or ambiguous and could have been prevented – or at least detected and dealt with – before they resulted in such material financial losses for the municipality. None of the material irregularities were as a result of human error, but were rather due to poor processes and judgement. There were most definitely indicators of fraud in some of these material irregularities, which have been (or will still be) uncovered by the investigations.

## PREVENTING MATERIAL IRREGULARITIES

The system of accountability has reached a point where **municipal managers must invest in preventative controls**. Preventing material irregularities is more effective than having to deal with the consequences thereof – money is lost, costly investigations have to be instituted and officials are subjected to the discomfort and anxieties associated with these processes, which often take a number of years.

Our message has been consistent over the years that a strong control environment and processes are key to achieving objectives, addressing risks, ensuring compliance with legislation, and managing public sector funds to the benefit of citizens. We acknowledge that it takes time to institutionalise good controls, especially in large and complex environments, but municipal managers need to **build their municipalities towards accomplishing this in a deliberate manner**.

We encourage municipal managers to **identify the areas of greatest risk in their institutions and focus on strengthening those areas first** – by applying the 80:20 rule, the greatest impact can be achieved through the lowest effort by focusing on the 20% that will bring 80% of the results.

In the context of material irregularities, the three key areas where municipalities are vulnerable to material financial losses, based on our findings in this first phase of implementation, are **awarding contracts, safeguarding assets, and making payments**. Controls should be implemented to prevent deviations from the procurement process resulting in overpricing, the loss of assets as a result of theft and vandalism, and paying for goods and services not received.

The preventative controls will only operate effectively and consistently if they are built on a **strong control environment** driven by the municipal leadership. Such an environment is characterised by the following:

- A culture of ethical behaviour and commitment to good governance and accountability enabled and inspired by the words and actions of the **leadership** of the municipality.
- **Adequate and sufficiently skilled officials** who know what their responsibilities are towards internal controls, as it is included in their job descriptions and often communicated, while their performance is monitored.

- Comprehensive **policies and procedures** that define principles and processes for officials to follow when they are performing their duties.
- Mechanisms for officials to report any pressure on them to act (for example, make decisions or payments) in a manner that is not in accordance with policies, procedures or codes of ethics. Such **whistleblowing mechanisms** should protect the official and enable swift and appropriate action against the implicated parties.
- **Risk management** through regular risk assessments (including fraud risk) and the development and implementation of mitigating measures, such as internal controls.
- A **combined assurance model** whereby different levels of management, the internal audit unit and the audit committee all work towards strengthening controls through monitoring and oversight.

The **council** can also play an important role in preventing material irregularities through the municipal public accounts committee. As detailed earlier in this section, the committees can use the information we provide on material irregularities in the audit report and general reports to call municipal managers to account on how reported material irregularities are being resolved. However, a more proactive approach by the council geared towards prevention will have an even greater impact. Such an approach should be aimed at identifying risks for material irregularities and requiring assurance from municipal managers that these risks are being mitigated through a strong control environment and the type of preventative activities detailed above. Our briefings to the mayor, council and municipal public accounts committee on, for example, the status of records will be a good source of information on risks and the status of controls. But we also strongly encourage engagement with the chair of the audit committee and the head of the internal audit unit on their perspective, as they have a key responsibility to assess risk and control.

As we continue on our journey to implement the material irregularity process, we hope to see a definite move towards the prevention of material irregularities to the benefit of the financial management, reputation and service delivery of municipalities – and ultimately the lives of the citizens they serve.



