SECTION 1

Executive summary

EXECUTIVE SUMMARY

This general report deals with the audit outcomes of local government for the financial year ended 30 June 2018. It **precedes the amendments to the Public Audit Act** which became effective on 1 April 2019. Accordingly, the requirements of these amendments will be applicable for the first time to audit reports issued for the financial years which ended on or after 31 March 2019.

These amendments introduce the concept of a **material irregularity** in audits performed under the Public Audit Act and, once a material irregularity has been identified, may result in a number of possible actions, including the referral of the material irregularity to an investigative body, where there are complex and intricate matters not capable of being concluded directly by the audit. Once a recommendation is made through an audit, such will be required to be effected within a period prescribed by the auditors; failing which, a binding remedial action will be issued by the auditors to the accounting officer to correct the identified material irregularity, also within a prescribed period. The last recourse, after all the above steps have been exhausted, will be for the Auditor-General to consider initiating a process that would trigger a certificate of debt in the name of an accounting officer or accounting authority associated with such material irregularity, once all the relevant, appropriate evidence has been secured.

Accountability and the need for appropriate consequences for accountability failures featured as prominent elements of our messages in our previous general reports and through the many engagements we have had with the political and administrative leadership in local government. We highlighted the shortcomings we identified through our audits and we provided many recommendations to improve accountability – yet we continue to see a deterioration in accountability. The key message that we can take from the 2017-18 audits is that the various role players have been slow in implementing our recommendations and in many instances even blatantly disregarded them. As a result, the **accountability for financial and performance management continued to deteriorate. This continued lack of accountability** prompted the amendments to the Public Audit Act. In our next general report, we will report on the **material irregularities** identified during our **2018-19** audits of the municipalities.

The three main indicators of the deteriorating accountability

1. **Audit outcomes regressed and irregular expenditure remains high**

   - **Overall, the audit outcomes regressed**. The audit outcomes of 63 municipalities regressed while those of 22 improved. Only 18 municipalities managed to publish quality financial statements and performance reports and to comply with key legislation applicable to financial and performance management, thereby receiving a clean audit – a regression from 33 in the previous year.
   - Credible **financial statements and performance reports** are crucial to enable accountability and transparency, but municipalities are failing in these areas. Countrywide, 21 municipalities submitted their financial statements late and the financial statements of eight were still outstanding by 31 January. Not only did the unqualified opinions on the financial statements decrease from 61% to only 51%, but the quality of the financial statements provided to us for auditing was even worse than in the previous year. Only 19% of the municipalities could give us financial statements without material misstatements. In addition, the performance reports of 65% of the municipalities that produced such reports had material flaws and were not credible enough for the council or the public to use.
   - We reported **material non-compliance** with key legislation at 92% of the municipalities. Municipalities with material compliance findings on supply chain management increased from 72% to 81%. These are the **highest percentages of non-compliance since 2011-12.**
   - **Irregular expenditure remains high** but decreased from R29,7 billion to R25,2 billion after the record highs in the previous year as a result of the significant effort made by some municipalities in their first year of administration to identify and transparently report on the irregular expenditure incurred in prior years. This total includes the irregular expenditure of those municipalities at which the audits had not been completed by the cut-off date of this report (R4 billion). The amount could be even higher, as 46% of the municipalities were either qualified on the incomplete disclosure of irregular expenditure or disclosed in the financial statements that they did not know the full extent of irregular expenditure. In total, R17,3 billion (81%) of the irregular expenditure related to

expenses incurred in 2017-18 – representing 5% of the local government expenditure budget. It included R6,4 billion in payments made on ongoing contracts irregularly awarded in prior years – if the non-compliance was not investigated and condoned, the payments on these multi-year contracts continue to be viewed and disclosed as irregular expenditure. The top 10 contributors to irregular expenditure were responsible for just over half of the total amount of irregular expenditure.

2. **A lack of consequences for transgressions and irregularities**

   - Our consistent and insistent calls to effect consequences for transgressions and irregularities were not heeded. We reported **material non-compliance with legislation on implementing consequences at 60% of the municipalities** – an increase from 54% in the previous year.
   - We found that 74% of the municipalities did not adequately follow up **allegations of financial and supply chain management misconduct and fraud** and that 45% of the municipalities did not have all the required mechanisms for reporting and investigating transgressions or possible fraud.
   - Inadequate follow-up was also evident in municipalities again not paying sufficient attention to **the findings on supply chain management and the indicators of possible fraud or improper conduct that we reported** and recommended for investigation. More than half of the municipalities did not investigate any of the findings reported. Where investigations did take place, 34% of the municipalities failed to resolve all of the findings satisfactorily.
   - At 62% of the municipalities, the council failed to conduct the required investigations into all instances of unauthorised, irregular and fruitless and wasteful expenditure reported in the previous year – a slight regression from 60% in the previous year. **Sufficient steps were also not taken to recover, write off, approve or condone** unauthorised, irregular and fruitless and wasteful expenditure as required by legislation. As a result, the year-end balance of irregular expenditure that had accumulated over many years and had not been dealt with totalled R71,1 billion, while that of unauthorised expenditure was R46,2 billion and that of fruitless and wasteful expenditure was R4,5 billion.

3. **Increasingly difficult environment for auditors and other role players in accountability**

   - **The audit environment became more hostile** with increased contestation of audit findings and pushbacks whereby our audit processes and the motives of our audit teams were questioned. At some municipalities, pressure was placed on audit teams to change conclusions purely to avoid negative audit outcomes or the disclosure of irregular expenditure – without sufficient grounds. Instances of threats and intimidation were experienced in most of the provinces.
   - The regular occurrence of **service delivery protests** at municipalities also delayed and interrupted our audits, as we could not always obtain access to municipal records and, in some cases, our staff members were removed from municipal premises for their own safety.
   - The **lack of commitment towards responding to our recommendations and to the early warning system** we have implemented through the status of records review, is a source of great frustration as it has an adverse effect on the efforts we make and seems to have limited impact.
   - The lack of impact in spite of the significant efforts made not only affected the auditors, but also extended to other accountability role players, such as **internal audit units, audit committees and municipal public accounts committees**. At some municipalities, the recommendations of these role players were not implemented, which made it difficult for them to have a positive impact on the audit outcomes. The **treasuries and cooperative governance departments** are the key national and provincial role players in influencing positive audit outcomes and favourable service delivery initiatives. Some municipalities did not implement the programmes initiated by them and did not respond to their support initiatives. Examples of such initiatives include the **Municipal Standard Chart of Accounts, minimum competency levels** and **back-to-basics programme**. The **Municipal Standard Chart of Accounts** enables the uniform recording and collection of local government budget, financial and non-financial information. Full implementation was required by 1 July 2017 – the regulations were issued in 2014. At year-end, some municipalities including three metros had not yet fully implemented this important initiative.

The impact of deteriorating accountability

The accountability failures in local government result in municipalities not achieving their objectives, which in turn has a negative impact on the lives of citizens. Our audits highlighted **two key areas of impact**: the financial health of municipalities and the delivery and maintenance of municipal infrastructure.

There are increasing indicators of a **collapse in local government finances** – we assessed 76% of the municipalities to have a financial health status that was either concerning or requiring urgent intervention. Almost a third of the municipalities were in a particularly vulnerable financial position.

The inability to collect debt from municipal consumers was widespread. In these circumstances, it is inevitable that municipalities will struggle to balance the books. Overall, 34% of the municipalities disclosed a deficit (in other words, their expenditure exceeded their income) – the total deficit for these municipalities amounted to R5,8 billion.

The financial woes of local government also weighed heavily on municipal creditors. The average creditor-payment period was 174 days. At year-end, R48,5 billion was owed to municipal creditors but the cash available amounted to only R37,3 billion. The money owed to Eskom by year-end was in arrears of R9,1 billion, of which R7,5 billion had already been outstanding for more than 120 days. The water boards also struggled to collect money owed by municipalities – their accounts were R5,9 billion in arrears, of which R4,4 billion was for more than 120 days.

While the poor economic climate does play a role in the deterioration of municipalities' financial health, many are just not managing their finances as well as they should. Fruitless and wasteful expenditure amounted to R1,3 billion, which is effectively money lost. The potential R1,6 billion loss of investments made with VBS Mutual Bank also significantly weakened the financial position of the 16 affected municipalities and had an impact on the delivery of infrastructure and maintenance projects.

Five provinces responded to the impending financial crises through provincial intervention by placing a total of 18 municipalities under administration.

Our audits again identified a number of **shortcomings in the development and maintenance of infrastructure**. The main findings on infrastructure development projects related to the underspending of grants, delays in project completion, and non-compliance with supply chain management legislation.

A key concern is the lack of attention paid to water and sanitation infrastructure – the condition of water and/or sanitation infrastructure was not assessed by 32% of the municipalities responsible for water and sanitation; and almost half did not have policies for maintenance. It is not unexpected then, that 39% of the municipalities that disclosed their water losses reported losses of more than 30%, resulting in an overall loss of R2,6 billion.

The maintenance of roads also did not receive the necessary attention, with the condition of roads not being assessed by 23% of the municipalities responsible for roads and 41% not having a road maintenance plan.

The audit outcomes in the provinces and of metros

The **Eastern Cape** regressed slightly for the second year in a row, after a trend of improvement in prior years – five municipalities regressed and four improved. Very few of the recommendations we made in the previous year and through in-year engagements received attention from the leadership. A culture of impunity has developed as a result of tolerance for non-compliance and a lack of consequences. This resulted in the irregular expenditure of Eastern Cape municipalities being the highest of all the provinces – at R7,3 billion, it accounted for 34% of the total. Overall, 15% of the province's local government budget was spent irregularly. The closing balance of irregular expenditure was a concerning R25,5 billion.

A total breakdown in controls and poor leadership response towards improving accountability, capacity and stability in municipalities were the main causes of further regressions in the **Free State**. Nine municipalities regressed and no improvements were noted in the province. The audit outcomes of nine municipalities were outstanding by the cut-off date for inclusion in this report, as a result of the late or non-submission of financial statements. The deterioration of the local government environment was also evident in the vulnerable financial position of 100% of the municipalities, the increase in irregular expenditure as a result of widespread indifference towards procuring goods and services within the legislated rules, and significant deficiencies in infrastructure projects.

The results in **Gauteng** held steady with all municipalities maintaining their good outcomes from the previous year. This was the only province in which all of the municipalities had unqualified audit opinions. Nevertheless, the municipalities need to pay attention to the quality of the financial statements submitted for auditing and continue improving the quality of performance reporting. Most importantly, however, is addressing the non-compliance with legislation – this remains the major obstacle preventing most municipalities in the province from achieving a clean audit. The expanding Gauteng population, as well as the resultant increased infrastructure development and maintenance needs, also placed a strain on capital expenditure spending. Two municipalities had investments with a combined value of R126 million at VBS Mutual Bank in contravention of the Municipal Investment Regulations, of which the recoverability is unlikely. The financial losses arising from these investments did not have an impact on service delivery for the current period as the funds were earmarked for long-term capital projects. However, this may have an impact on the multi-year projects in the next financial period if these funds are not catered for in the upcoming budget adjustment. Half of the municipalities were in a vulnerable financial position. The current economic climate has resulted in the financial sustainability of municipalities remaining constrained, as they continued to experience difficulties in collecting debt from municipal consumers.

KwaZulu-Natal continued on its downward spiral, which started in 2015-16, with 14 municipalities regressing in the current year. The leadership did not decisively deal with the weaknesses and risks we warned them about and again did not pay attention to internal controls. The levels of tension, intimidation and threats as well as pushbacks and hostility towards our audit teams, coupled with surges in service delivery protests, made auditing in this province complex and challenging. A blatant disregard for legislation and a lack of consequences for the high irregular expenditure continued to erode accountability, public trust and governance.

Limpopo was the only province with some improvement in the overall audit outcomes. The improvements were consultant-driven – 96% of the municipalities used consultants at a cost of R177 million. In spite of our warnings against over-reliance, the municipal leadership continued to use consultants as a short-term remedy rather than focusing on improving capacity and skills in the finance units and improving the control environment. It is likely that outcomes will remain erratic until sustainable solutions are implemented. Eight municipalities had investments with VBS Mutual Bank in contravention of the Municipal Investment Regulations. Due to the pending liquidation process, the recoverability of the R1,2 billion invested is unlikely. The resultant lack of funds affected the ability of these municipalities to deliver on infrastructure and maintenance projects in the current year and could have a negative impact on the achievement of service delivery objectives in the coming years. This also further contributed to the poor financial state of municipalities within the province, with more than half of them reporting a deficit, as their expenses exceeded their income. In addition, there were high levels of unauthorised expenditure and two municipalities were placed under administration.

Mpumalanga was unable to sustain the improved audit outcomes from the previous year and showed a significant regression in the audit outcomes. Our continued calls on the municipal and political leadership to address vacancies, instability and competency gaps, institutionalise internal controls and deal decisively with accountability failures were not heeded, leading to nine municipalities regressing and only one improving. Municipalities continued to underperform on their planned projects and the disregard for legislative prescripts (especially supply chain management legislation) remained widespread. Poor financial management led to the further weakening of financial health, which affected the payment of creditors – the Eskom accounts of municipalities were in arrears of almost R3 billion. The severely weakened financial health of the province resulted in provincial intervention at four municipalities. The audit environment became more hostile with subtle threats against our auditors and some municipalities submitting falsified audit evidence to avoid audit findings. In response, we have engaged the municipal leadership and urged them to set the right behavioural tone.

The overall audit outcomes in the **Northern Cape** regressed, with only two municipalities improving and five regressing. As in prior years, not all the audits were completed on time for inclusion in this report, as the financial statements were submitted late. Every year our message is that mayors, municipal managers and senior managers need to hold each other and their subordinates accountable, but this message has been met with little response. Vacancies and a lack of skills again resulted in an over-reliance on consultants and auditors. It is also becoming evident that the municipal leadership does not take compliance with legislation seriously, which exposes municipalities to the misuse of public funds. Financial health further deteriorated, with 64% of the municipalities now in a financially vulnerable position. The lack of accountability has become embedded in the culture of the province, which undermines the basic principles of transparency and good governance.

The audit outcomes of **North West**, the worst since 2012-13, clearly indicated the deteriorating accountability, a blatant disregard of our messages and recommendations, complacency and a lack of commitment to decisively address key areas of concern as well as a lack of political will to effect consequences. Despite the commitments made by the leadership, they did not respond with the required urgency to our messages about addressing risks and improving internal controls. The political instability in the province and the tone set by the leadership created an environment that was not conducive to accountability, good governance and the effecting of consequences. The audit environment also became more hostile, with increased contestations of audit findings, pushbacks and subtle threats by municipalities, with our auditors' integrity being questioned. Five municipalities had investments with a combined value of R551,2 million at VBS Mutual Bank in contravention of the Municipal Investment Regulations. Due to the pending liquidation process, the recoverability of R316,7 million is unlikely. The financial losses arising from these investments gave rise to difficulties in paying for operational expenses and affected the municipalities' ability to start or complete projects, thus affecting service delivery. In response to the poor state of financial management, service delivery, governance and oversight, the province intervened at eight municipalities – the impact of which will only be evident from our next audit. The political and administrative leadership will have to come up with extraordinary measures and efforts to address the deteriorating state of local government in North West.

The largest concentration of municipalities with clean audits was still in the **Western Cape** (40%), but there was a significant regression from the previous year as the audit outcomes of nine municipalities regressed. We have observed that the lapses in controls in certain municipalities in this province were largely non-adherence to statutory submission dates of financial statements for auditing as well as non-adherence to supply chain requirements in confined areas already identified and actioned by management only after the audit. For these reasons, we do not believe that these lapses or control deviations are indicative of a systematic breakdown in the systems of internal control; however, this report had to reflect the occurrences to prevent management complacency.

There were municipalities across the country that were able to **consistently achieve a clean audit status** even though they faced similar challenges than their counterparts. Twelve of these municipalities were in the Western Cape and included the local municipalities of Swellendam, Witzenberg, Bergrivier, Breede Valley, Cape Agulhas, Cederberg, Hessequa, Matzikama and Overstrand. Other municipalities that consistently perform well were Senqu (Eastern Cape), Midvaal (Gauteng) and Okhahlamba (KwaZulu-Natal). The best practices we noticed at these municipalities included stable leadership that is committed to a strong control environment and effective governance. Continuous monitoring of their audit action plans in order to timeously address any findings we identify and a proactive approach to dealing with emerging risks were also common features at these municipalities.

It is unfortunate that these limited excellent practices are often dwarfed by the pervasive control and monitoring failures evident at a significant number of other municipalities across the country. The impact is that the fiscal resources placed at their disposal are either misused or not properly accounted for as required by public finance management laws. The **trickle-down effect of these failures on services** has been glaringly evident over the years across a number of municipalities, large and small. Evidence of these is largely incomplete projects, unsupervised projects, lack of maintenance of significant service delivery infrastructure, and haphazard road maintenance projects and infrastructure. Contained in the detail of this report are examples of these deficiencies and municipalities where they are prevalent.

Overall, the **audit outcomes of the audited metros** remained the same, with only Buffalo City regressing (the audit outcome of Mangaung was still outstanding at the cut-off date of this report). Although 71% of the metros produced unqualified financial statements, only 57% had credible performance reports and all of them had material compliance findings. The irregular expenditure decreased by 43% at the metros. The high irregular expenditure in the previous year was mostly as a result of uncovering and disclosing irregular expenditure from prior years, which was no longer the case in the current year. The financial health of most of the metros remained unchanged from the previous year, but we raised concerns about the City of Johannesburg and Nelson Mandela Bay, with the City of Tshwane being in a particularly vulnerable financial position.

Addressing the deteriorating accountability

There were **varied reasons for the accountability failures:**

- **Vacancies and instability in key positions** slowed down systematic and disciplined improvements.
- Key officials **lacked appropriate skills and competencies** for financial reporting, which led to over-reliance on consultants and negatively affected financial planning, record keeping and reporting.
- **Reporting on the performance** of municipalities was **not taken seriously**. There were inadequate systems to collate and report performance information; and officials did not understand or could not apply the performance management and reporting requirements.
- **Poor monitoring and review processes** by senior management allowed errors and non-compliance to go undetected.
- Leadership's inaction, or inconsistent action, created a culture of **no consequences**.
- Leadership did not take our **repeated recommendations and warnings** of risks for which they needed to prepare seriously. The action plans developed were inadequate or just not implemented.
- At some municipalities, there was a **blatant disregard** for controls (including good record keeping) and compliance with key legislation.
- **Political infighting** at council level and interference in the administration weakened oversight and did not enable the effecting of consequences.

The **leadership sets the tone at the top** at municipalities. If the municipality's leaders are unethical; have a disregard for governance, compliance and control; and are not committed to transparency and accountability, it will filter through to the lower levels of the municipality. Inevitably, a culture of poor discipline, impunity and non-delivery will develop, leading to the collapse of the municipality.

Local government leadership (political and municipal leaders as well as provincial leadership) should take responsibility for the accountability failures of municipalities. It is their **duty to turn the situation around**, which they can start doing by focusing on the following:

- Set the tone from the top through ethical leadership, good governance and accountability.
- Capacitate and stabilise the municipal administration and keep it free from political interference.
- Enable and insist on robust financial and performance management processes and controls as well as regular, credible reporting to enable all levels of leadership to perform their monitoring and oversight function.
- Ensure consistent, appropriate and swift consequences for transgressions and irregularities.

As the Auditor-General of South Africa, we have **an important role to play in the accountability chain** and we go beyond the basic auditing and reporting role of the auditor. Through our management, audit and general reports, we have been reporting the weaknesses in internal control and the risks that need attention in local government. In our reports, we provide root causes for audit findings and recommendations to address the root causes. We ensure that our messages are heard through engagements with senior officials, municipal managers, mayors, municipal public accounts committees, and councils.

In the past year, we have further increased our efforts by using the **status of records review** to engage with municipal managers. Such a review is an assessment of records, risks and progress made by the municipality to address prior year issues early in the financial year. This provides an early warning system whereby municipal managers can be alerted to matters that can potentially lead to undesirable audit outcomes. In spite of repeated warnings of risks and weaknesses identified during these reviews, the municipal managers did not act, resulting in the accountability failures as detailed in this report.

All of these measures are aimed at assisting the municipal leadership and the council to prevent accountability failures, or to provide them with information on how to deal with such failures where they have occurred. Despite our effort, these value-adding practices have not had the desired impact yet – as evidenced in the poor audit outcomes.

The accountability mechanisms in local government are not working as they should, and there have been continued calls for more to be done – particularly by my office. The amendments to the **Public Audit Act** provide us with more power to ensure accountability in the public sector, but the intent of the amendments is not to take over the functions of the municipal manager, the mayor or the council, as their accountability responsibilities are clear in municipal legislation. It is rather to step in where those responsibilities are not fulfilled in spite of us alerting leadership to material irregularities that need to be investigated and addressed.

If municipal managers, supported by their political leadership, adhere to their legislated responsibilities and commit to taking swift action when we notify them of a material irregularity, there will be no need for us to use our remedial and referral powers. Material irregularities can also be prevented if municipal managers pay attention to the warning signals we share with them as part of the status of records reviews and to our recommendations on improving internal controls.

The extension of our mandate to deal with these types of irregularities will assist in restoring public confidence, solidifying accountability, and entrenching the ethical behaviour that is expected of entrusted officials and elected representatives. It will also mean that our reports will be taken seriously and we could start to see an improvement in the audit outcomes.

My office remains committed to working tirelessly within our expanded mandate to strengthen financial and performance management in local government in South Africa, emphasising the need for accountability and doing the basics right. We encourage the municipal leadership and all stakeholders involved in local government to intensify their efforts to ensure that communities experience an improvement in the way their municipalities operate.

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