4 Status of state-owned enterprises

4. *Status of state-owned enterprises*

The public entities defined in the Public Finance Management Act (PFMA) include government business enterprises, more commonly known as state-owned enterprises or SOEs. In this section, we specifically **focus on the status of major public entities**, as listed in schedule 2 of the PFMA. These SOEs are independent entities partially or fully owned by the state to achieve the various socio-economic goals of government – they are expected to fulfil a dual commercial and developmental mandate.

Most of these SOEs have a **direct impact on the lives of citizens** through the services and infrastructure they provide. Poor governance, mismanagement, fraud and corruption claims and a lack of financial sustainability at some of the SOEs have been in the spotlight for the past few years – attracting attention as taxpayers' money is used to sustain the failing SOEs. As this narrative contributes to the loss of public confidence in the ability of the state to govern and oversee these SOEs, we have included our findings on the state of SOEs in this report based on our audits.

We **do not audit all the SOEs** – some are audited by private audit firms in accordance with the directives we provide using our methodology for auditing compliance and performance information. These audit firms are appointed by the boards of the SOEs. We maintain a close relationship with the appointed audit firms, in particular with those auditing SOEs we categorised as **significant-risk entities**. It allows us to continuously increase our oversight and involvement in these audits in order to improve consistency in auditing and reporting on all SOEs and to provide guidance and support on technical and governance matters. We can opt to perform these audits and we have significantly increased the number of SOEs we audit over the past few years.

Table 1 shows which audits we performed in 2016-17 and on which we report in this section. It also shows those audited by audit firms and which have been identified as significant-risk entities for increased oversight by the Auditor-General of South Africa (AGSA). Their audit outcomes are not included in the analysis in this section but we include some observations in this regard. The subsidiaries that are classified as small auditees are not included in the table below or in our analysis.

The **budgets** administered by the 25 SOEs (including the subsidiaries) we audit totalled R31 billion in 2016-17 – 17% of the total public entity budget and 3% of the total 2016-17 budget of departments and public entities.

Table 1: Audit of state-owned enterprises

SOEs audited by the AGSA	SOEs audited by audit firms
• Independent Development Trust • Acsa • Sapo *and its subsidiary Courier and Freight Group* • Land Bank *and its subsidiaries Land Bank Life Insurance and Land Bank Insurance* • Armscor • SABC • Central Energy Fund *and its subsidiaries PetroSA, PetroSA Ghana, SA Agency for Promotion of Petroleum Exploration and Exploitation (Petroleum Agency SA), and Strategic Fuel Fund* • Necsa *and its subsidiaries Gammatec NDT Supplies, NTP Radioisotopes and Pelchem* • SA Express • South African Forest Company (Safcol) *and its subsidiary Komatiland Forests* • SAA *and its subsidiaries Air Chefs, Mango Airlines and SAA Technical*	• Telkom SA *and its subsidiaries* • Trans-Caledon Tunnel Authority • Industrial Development Corporation of South Africa • Alexkor • Broadband Infraco • Development Bank of Southern Africa • Air Traffic and Navigation Service Company **Significant-risk SOEs audited by audit firms** • Denel *and its subsidiaries* • Transnet *and its subsidiaries* • Eskom *and its subsidiaries*

Overall audit outcomes

We set the cut-off date for inclusion of the audit outcomes in this report as 31 August 2017. By this date, the following six **audits had not been completed**:

- **SAA and subsidiaries** (four SOEs) – this is the first year that we have audited the SAA group. Except for Mango Airlines, we have not yet received the final financial statements of the group. The four companies in the SAA group received clean audits in the previous year.
- **SA Express** again submitted their financial statements late (only by 31 August). This company received a qualified audit opinion last year with material findings on their performance reporting and compliance with legislation.
- The **Independent Development Trust** received a qualified audit opinion in 2013-14 and subsequently received disclaimed opinions in the 2014-15 and 2015-16 financial years after deficiencies were identified in management's processes to appropriately account for programme expenditure. The delay in submitting information had an overall negative impact on the timely finalisation of the 2016-17 audit. The audit was subsequently completed but was too late to be included in the analysis in this report. The entity again received a disclaimed opinion as information was not available to support the occurrence of programme expenditure in the financial year it related to with material findings on performance reporting and compliance with SCM legislation. However, the entity had made progress in some areas since the previous year.

Figure 1 reflects the audit outcomes of the 19 completed audits over four years.

Figure 1: Audit outcomes over four years

The **audit outcomes regressed** over the four-year period and from the previous year – the outcomes are likely to be even worse once the outstanding audit results are included.

The SOEs with **clean audit outcomes** were Armscor (for the past three years), Land Bank Life Insurance (for the past three years) and three SOE subsidiaries that had improved to a clean audit status (Gammatec NDT Supplies, NTP Radioisotopes and PetroSA Ghana). Petroleum Agency SA and Land Bank Insurance lost their clean audit status of the previous year as a result of material non-compliance with legislation.

The audit outcomes of the **SOEs audited by private audit firms** (which are not included in the graphic above) **also regressed** from the previous year. The following three regressed:

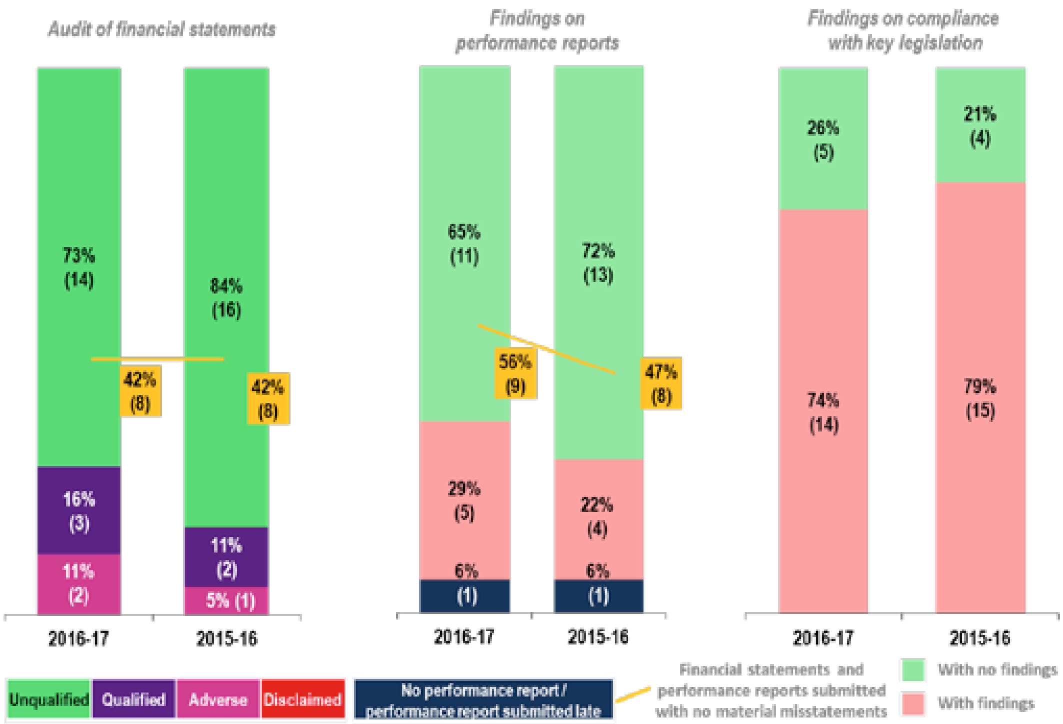
- Broadband Infraco lost its clean audit status as a result of material findings on compliance and their performance report, while Air Traffic Navigate Services did so as a result of various material misstatements in their financial statements and material findings on compliance with legislation.
- Eskom was qualified as all irregular expenditure incurred was not disclosed and due to material findings on compliance with SCM legislation.

The audit opinion of Transnet remained unchanged as unqualified with findings on performance reporting and compliance.

The audit opinion of Denel had not yet been finalised at the date of this report.

Figure 2 shows the audit opinions on the financial statements and the findings on the performance reports over two years as well as the percentage of SOEs that submitted financial statements and performance reports without material misstatements (orange line). It also shows the number of SOEs that had material findings on compliance with key legislation in the past two years.

Figure 2: Audit outcomes on three key areas



As shown in figure 2, the SOEs regressed in all areas except for compliance with legislation in which there was a slight improvement. The **regression in the quality of the financial statements** was as a result of the following:

- The SABC regressed from a qualified opinion to an adverse opinion and the Courier and Freight Group (a subsidiary of Sapo) retained its previous year's adverse opinion – both had various material misstatements in their financial statements and could not substantiate that they are going concerns (going concern is discussed later on in this section).
- Sapo remained qualified in areas such as property, plant and equipment as well as irregular expenditure.
- Safcol and its subsidiary Komatiland Forests regressed to a qualified opinion, as they did not disclose all the irregular expenditure incurred.

Although 14 SOEs had unqualified audit opinions, only eight submitted financial statements without material misstatements. This means that six SOEs, which include Acsa, Necsa and most of the Central Energy Fund group, received an **unqualified opinion only because they corrected all the misstatements we had identified in the audit**.

We highlight the following with regard to the **performance reports** of the SOEs:

- The Courier and Freight Group again did not prepare a report on its performance as required by the PFMA.
- Some of the indicators and targets reported on by the SABC and Sapo were not useful, as there was no clear and logical link between the indicator and the strategic objective to which it related (SABC) or the source of information and method of calculation and/or the target set was not clearly defined (Sapo). Both these SOEs also did not report in a reliable manner, as some of the achievements were misstated or we could not find evidence that substantiated the achievements.
- Safcol, Acsa and PetroSA also did not report reliably – but only on a few targets.

The indicators and targets in the performance reports form an important tool for shareholder departments and ministers to keep SOEs accountable against set outcomes and goals. Weaknesses in the performance reports therefore need to be addressed to ensure that the direction and oversight provided by the shareholders are clear and focus on the things that matter.

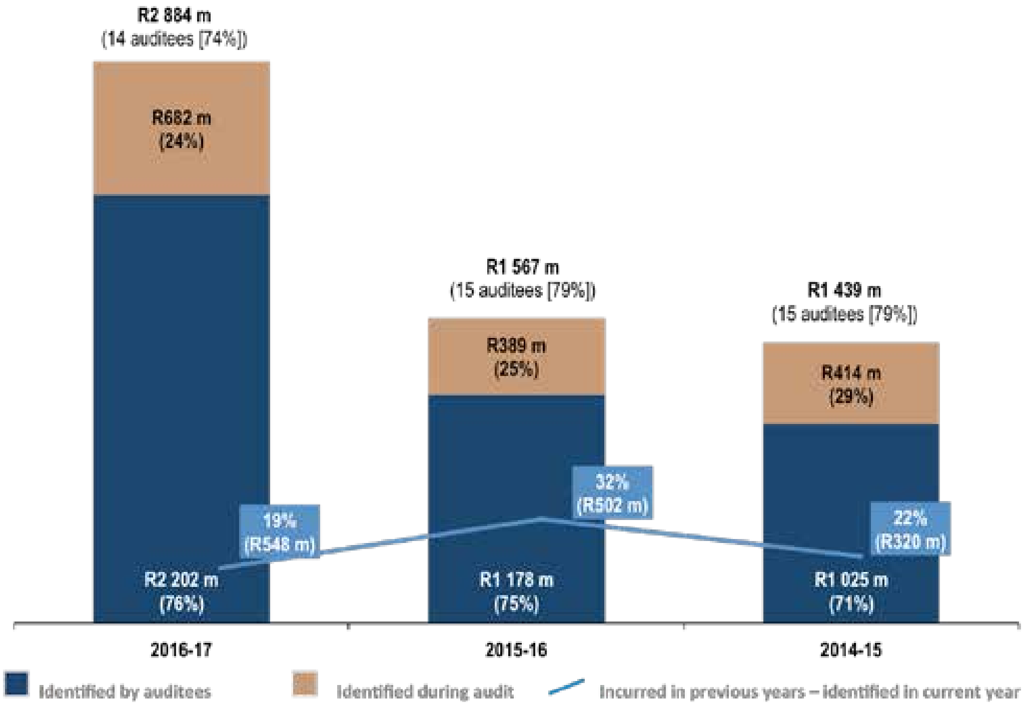
The **slight improvement in compliance with legislation** was as a result of three SOEs addressing their previous year's findings, but two regressing in this area.

The internal controls that should ensure the quality of financial statements and performance reports as well as compliance with legislation were not in place at all SOEs, resulting in these outcomes.
The weakest control areas were their policies and procedures, IT system controls, and compliance monitoring. A discipline of regular in-year reporting and monitoring of financial and non-financial results had also not been established.

Irregular expenditure and supply chain management

Figure 3 shows the **three-year trend in irregular expenditure** based on the amounts that were disclosed in the financial statements of the SOEs. It also indicates the percentage of irregular expenditure identified by them versus that identified by the audit process as well as the proportion of irregular expenditure disclosed that had been incurred in previous years but only identified in the current year (blue line).

Figure 3: Irregular expenditure over three years



The number of SOEs with irregular expenditure decreased slightly but the **value increased significantly**. The main contributors were the following:

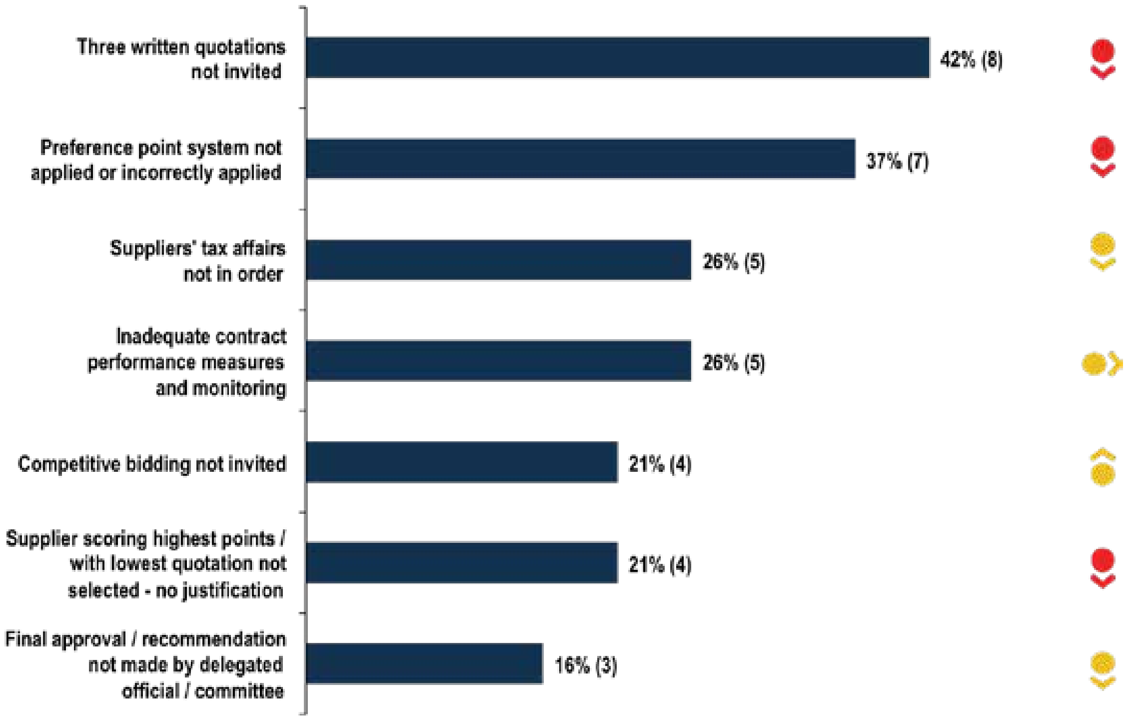
- Acsa – R1 169 million (2015-16: R134 million) – 60% was as a result of non-compliance with legislation on contracts.
- Sapo – R719 million (2015-16: R127 million) – 45% was as result of non-compliance with procurement process requirements and 37% as a result of not following competitive bidding or quotation processes.
- SABC – R687 million (2015-16: R764 million) – 75% was a result of not following competitive bidding or quotation processes.
- Komatiland Forests – R238 million (2015-16: R37 million) – 49% was a result of not following competitive bidding or quotation processes.

The irregular expenditure of the significant-risk SOEs we do not audit was:

- Eskom – R4 043 million
- Transnet – R923 million
- Denel – R146 million

Figure 4 shows the most common SCM findings at SOEs with an indication of the movement from the previous year.

Figure 4: Most common supply chain management findings



As shown in figure 4, the number of **SOEs with findings had increased** from 2015-16 in most areas.

The PFMA requires SOEs to put policies and processes in place to ensure that their procurement processes are fair, equitable, transparent and competitive. Although SCM policies were in place, we found that officials were not familiar with the policies and the procurement processes they should follow, and in some cases circumvented the processes. We could also not always find evidence for the decisions made to award contracts to certain suppliers.

Financial sustainability

Schedule 2 public entities are business enterprises that are required to generate revenue to fund their operations. However, some are dependent on government support in the form of government guarantees or subsidies. The state as owner has committed to ensuring that SOEs have adequate funding to operate and achieve their developmental and commercial objectives. The well-publicised financial woes of SOEs such as SAA, Sapo and the SABC put a spotlight on the financial sustainability of SOEs and the impact of their failures on dwindling state resources.

Our audits focused on some key aspects of the financial health of SOEs – in particular the assessment of going concern.

What is going concern?

The accounting standards require that when financial statements are prepared, management must assess the entity's ability to continue as a going concern. This means that they have to assess whether they will be able to continue their operations for at least another 12 months and will not go out of business and liquidate their assets.

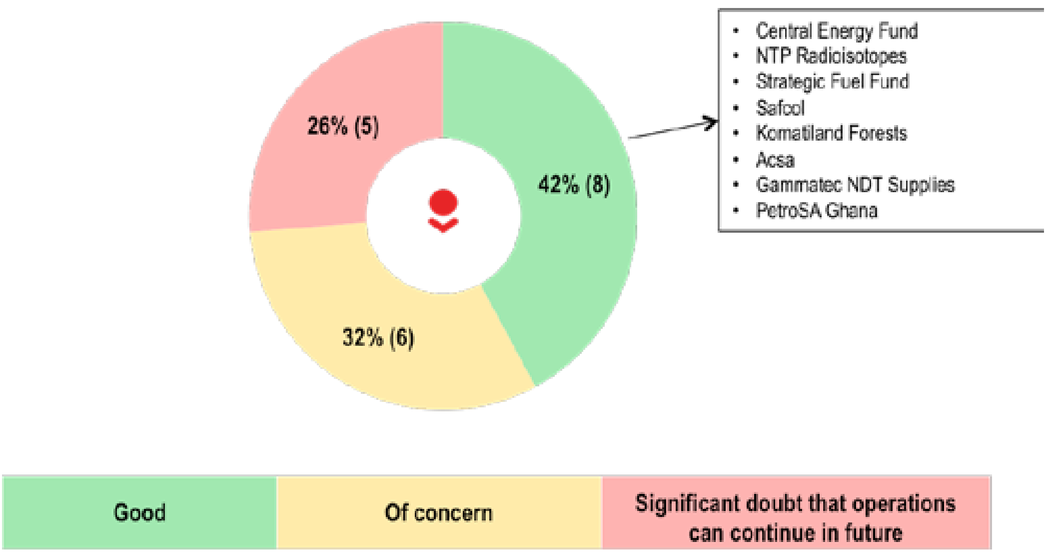
If they determine that the entity does not have the capacity or prospect to raise enough financial resources to stay operational, the financial statements need to be prepared as if they are going out of business.

If this assessment confirms that the entity is a going concern but identifies that there is a material uncertainty about their ability to continue as a going concern in future, this must be disclosed in the financial statements.

Our role as auditors is to audit management's assessment and obtain evidence about the appropriateness thereof.

Our assessment of the financial health of SOEs is shown in figure 5.

Figure 5: Status of financial health



The **financial health of SOEs had regressed from the previous year**. For just over a quarter of them there was significant doubt on whether they could continue their operations in future, as outlined below:

- The **SABC was commercially insolvent** by the end of the financial year. They incurred a net deficit (loss) for the past two years and we are of the opinion that they will not be able to pay their debt when it becomes due. Subsequent to year-end, they applied for a government guarantee to enable them to borrow money to settle their obligations. The SABC did not disclose these material financial uncertainties and we could not conclude on the viability of the SABC without a guarantee. As a result, their financial statements received an adverse opinion.
- **The Courier and Freight Group** is a subsidiary of Sapo, which made a substantial loss in 2016-17 and 2015-16 with their liabilities far exceeding their assets. As no arrangements were approved for Sapo to give financial assistance to their subsidiary, we deemed this company to **not be a going concern** and gave them an adverse opinion as their financial statements did not reflect this.
- **Sapo** itself disclosed that conditions existed (including a loss of R978 million) that were indicative of a **material uncertainty whether the company and the group could continue as a going concern.**

- **PetroSA and Pelchem** disclosed that they might also not be able to continue as a going concern in future based on the significant losses by these companies.

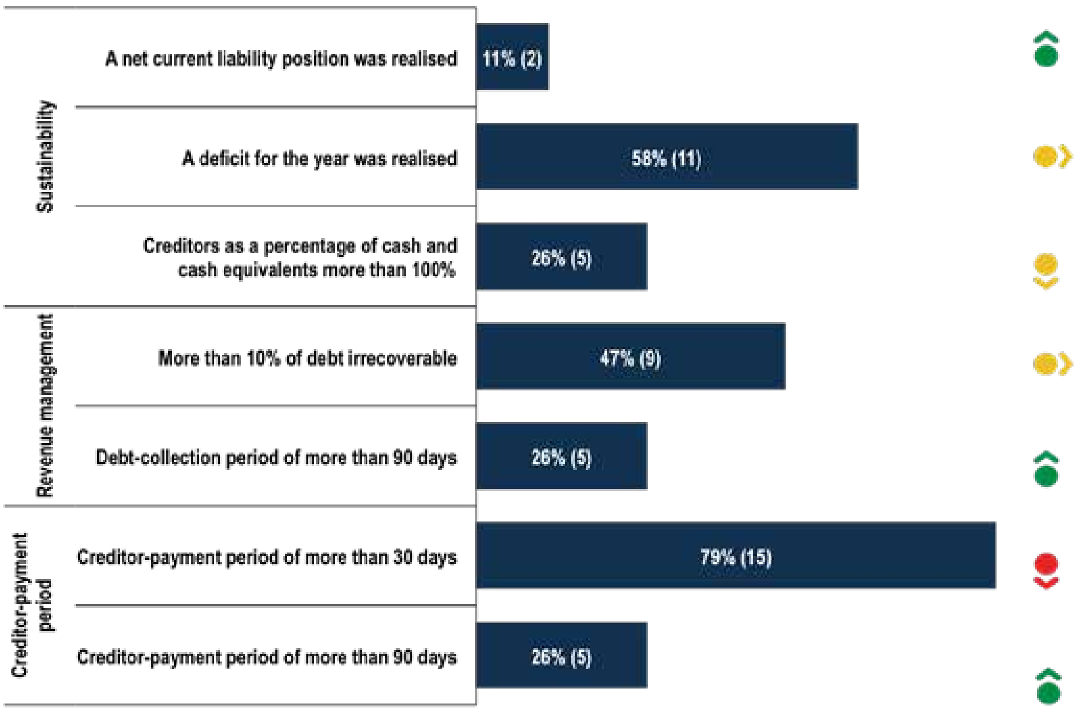
SAA and all its subsidiaries (except Mango Airlines) **had not submitted their financial statements** for auditing by the time of this report, as management could not conclude on whether these companies were going concerns.

We are also concerned that the **losses incurred in 2016-17** by **Armscor, Necsa, Land Bank Insurance and Petroleum Agency SA** could be an indication of a possible going concern problem at these entities in future. We also identified some concerning indicators at **Land Bank** itself and its other subsidiary **Land Bank Life Insurance**.

These SOEs have put forward various reasons for them recording less than favourable financial results in recent times. These include the downturn in the economic markets with most of these SOEs heavily exposed to the international markets; increased commodity prices that directly affect the SOEs due to their role as infrastructure providers to the South African economy; and weak commercial and financial decision-making where SOEs are trapped in onerous contracts. In our view, leadership instability, poor decision-making and inadequate financial management controls and processes also contributed to the poor financial state of SOEs.

Figure 6 provides an overview of the status of key financial indicators at the SOEs we audited and the movement from the previous year.

Figure 6: Financial health indicators



The government departments responsible for the SOEs issued guarantees with the approval of the minister of Finance for them to obtain funding from lenders and other external parties. These guarantees are issued in terms of the PFMA.

What is a guarantee?

'Guarantee' is a legal term more comprehensive and of higher importance than either warranty or security.

By granting a guarantee, the state is therefore providing surety to a lender that the state will repay amounts due to the lender in terms of the agreement if the SOE is not in a position to do so.

A guarantee is typically in the form of a letter confirming the conditions of the guarantee addressed to the SOE and signed by the minister of Finance.

A lender will typically be either a local or foreign bank.

These guarantees can be a direct charge to the **National Revenue Fund** should the SOEs default on their guaranteed liabilities. The fund keeps record of guarantees issued and the total exposure to the government. The audit of the National Revenue Fund will only be finalised after the date of this report, but based on the audit work already done, guarantees had been issued to 12 SOEs (including the SOEs not audited by us) to an amount of R440,26 billion and government had exposure to a total liability of R243 billion. Of the total guarantees, R350 billion was issued to Eskom, with a R203 billion exposure.

The amount stated as total exposure means that the SOEs utilised the guarantee to obtain loans from lenders. We also raised findings during the current year's audit on the incomplete and inaccurate recording of the guarantees and exposure.

We will continue to increase our audit focus on the ability of the state to back up these guarantees with funds if called upon to pay SOE creditors – as has been done for SAA.

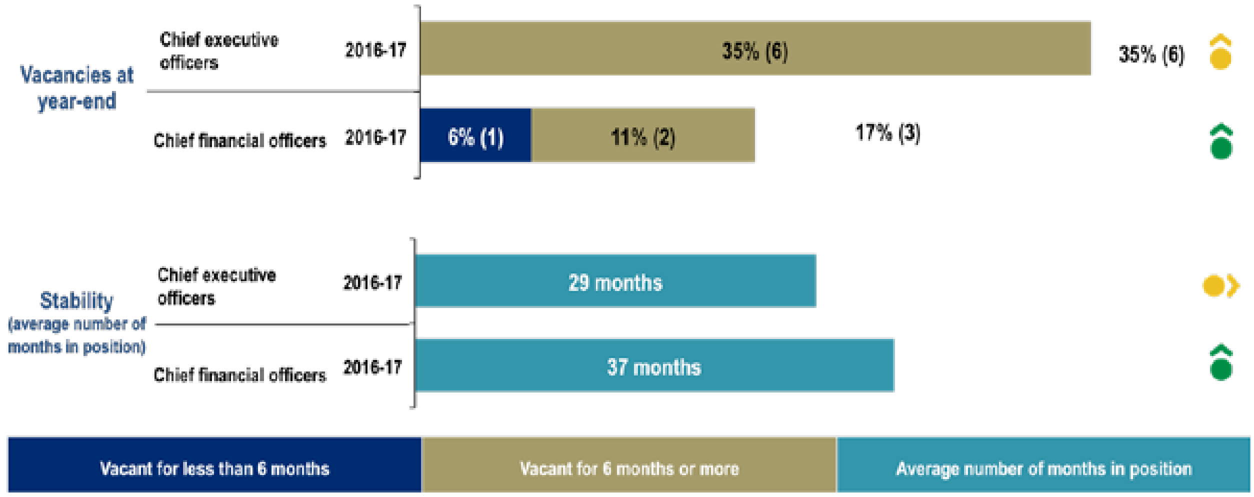
Most of the SOEs we audit are state-owned companies that are subject to the Companies Act. The act prohibits companies from carrying on its business recklessly or with gross negligence, and determines that directors can be held personally liable for any losses suffered as a result of such reckless trading.
As more and more state-owned companies cannot pay their debts as they become due, and government does not always provide the financial support requested (e.g. at the SABC and the Courier and Freight Group), directors are being placed in very difficult situations when they need to make business decisions or enter into contracts. Delays by government in making policy decisions on state-owned companies and how they will be financially supported further **worsen the outlook of state-owned companies in the short and medium term.**

Leadership instability and oversight

As part of our audits, we considered the leadership, financial and performance management as well as governance of auditees to identify the possible root causes of poor audit outcomes, irregular expenditure and financial health concerns.

Instability at board and executive levels played a role in the outcomes of SOEs. At the SABC, for example, the board did not quorate for most of the financial year and the interim board was put in place only at the end of the financial year. Figure 7 shows the extent of vacancies at year-end in the chief executive officer and chief financial officer positions as well as the period that the positions had been vacant. It further shows the average number of months the current incumbents had been in their positions.

Figure 7: Vacancies and stability



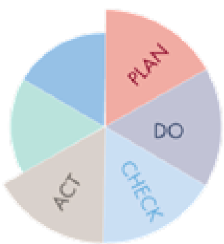
Six of the SOEs **did not have chief executive officers at year-end** – a slight improvement from the previous year. The chief executive officers at the other SOEs had only been in those positions for an average of nearly 2,5 years. The vacancy rate and stability in chief financial officer positions were less concerning and continued to improve.

Vacancies at senior management level further contributed to the weaknesses identified – the average vacancy rate was 17%, with both SOEs in the Safcol group at a 60% vacancy level. Generally, the **quality of the finance units** was acceptable (at 79%) – staff vacancies did have an impact at Acsa, while both vacancies and skills were a concern in the Sapo group.

An emerging risk is a lack of **appropriate skills at board level –** the bad reputation of some of the SOEs can also contribute to them not attracting the right level of skills and experience.

The **level of oversight by the departments** the SOEs report to differed and there was no single approach in this regard. The political leadership was also inconsistent – at some SOEs there was a high level of involvement, while at others the required decision-making and policy direction were not provided timeously (e.g. board appointments).

Conclusion



SOEs play an important role in South Africa: they need to be supported by the state but also called to account. Government should work towards a **consistent strategy** for SOEs, which includes firm commitments to support strategic SOEs where the economic climate is affecting their sustainability (**PLAN**). SOEs should **strengthen their financial and performance management systems** to account in a credible manner on their finances and performance (**DO**). The **oversight** by the departments, ministers and parliamentary committees responsible for the SOEs should include strong in-year monitoring and ensuring that governance policies and practices are in place (**CHECK**). Boards and chief executive officers should be **held accountable** for the delivery and financial results of the SOEs, and there must be immediate and effective consequences for poor performance and transgressions (**ACT**).