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The status of financial management

Back-to-basics:

Ensure sound financial management and accounting, and prudently manage resources to sustainably deliver services and bring development to communities

Figure 1: Three-year trend – audit of financial statements

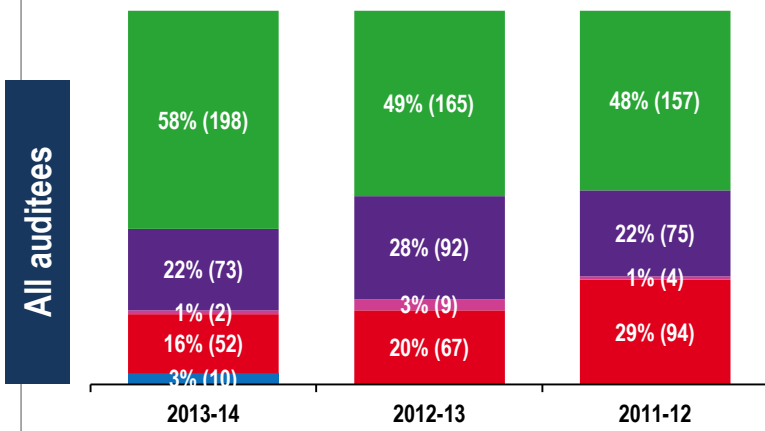


Figure 2: Status of submitted financial statements

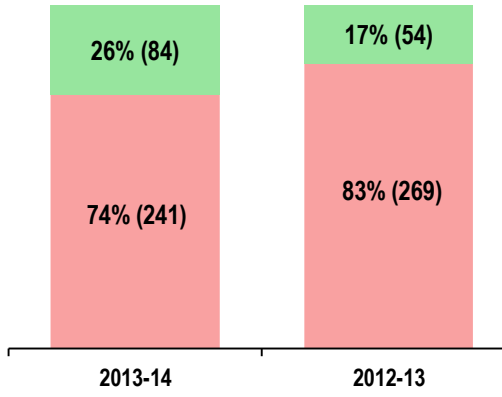
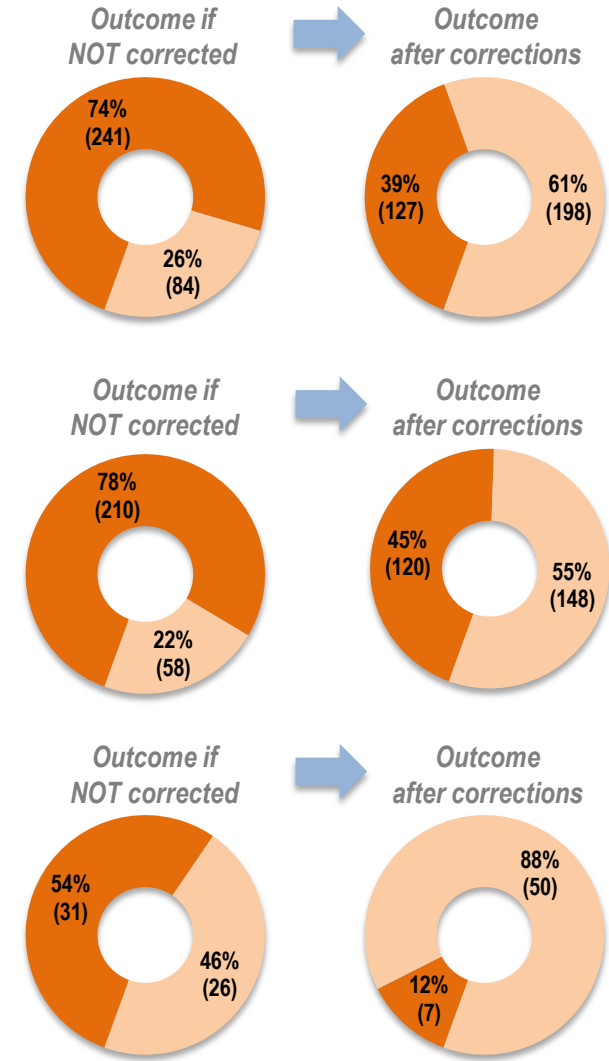


Figure 3: Quality of submitted financial statements (114 auditees [2012-13: 112] avoided qualifications due to the correction of material misstatements during the audit process)



All auditees

Municipalities (268 completed audits)

Municipal entities (57 completed audits)

Unqualified Qualified Adverse Disclaimed Outstanding audits

With no material misstatements With material misstatements

No material misstatements Material misstatements

3.1 Financial statements

The purpose of the annual audit of the financial statements is to provide the users thereof with an opinion on whether the financial statements fairly present, in all material respects, the key financial information for the reporting period in accordance with the financial framework and applicable legislation. The audit provides the users with reasonable assurance regarding the degree to which the financial statements are reliable and credible on the basis that the audit procedures performed did not reveal any material errors or omissions in the financial statements. We use the term *material misstatement* to refer to such material errors or omissions.

The Department of Cooperative Governance and Traditional Affairs' operation clean audit and the medium term strategic framework targets

CoGTA launched operation clean audit on 16 July 2009 with a vision that all municipalities (283 when launched) should 'achieve financially unqualified audit opinions'. The programme included milestones up to 2013-14 when all municipalities should have achieved unqualified audit opinions. The number of municipalities with unqualified audit opinions increased from 96 (34%) in 2007-08 to 148 (53%) in 2013-14, which falls short of the goal set.

The MTSF set new targets for improving the audit outcomes in pursuit of sound financial and administrative management (in a sub-outcome of outcome 9 that deals with a responsive, accountable, effective and efficient developmental local government system). The ministers of Finance and CoGTA are responsible for the actions and outcomes in this area, while the back-to-basics strategy of CoGTA further commits to this outcome. The targets for the financial audit opinions for the 2018-19 financial year are as follows:

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

The continuous improvement in the opinions on the financial statements, especially in the past year, is an encouraging sign that these targets are not out of reach. Treasuries and departments of cooperative governance should consider the analyses and recommendations that follow in this section to guide their programmes and plans to achieve the targets.

Status of, and movement in, audit opinions

Figure 1 shows that the audit opinions on the financial statements have improved since the previous year, with 58% (2012-13: 49%) of the financial statements now being unqualified.

Table 1 in section 2 on the overall audit outcomes indicates the movement in the financial audit outcomes. It shows that two auditees received an adverse opinion – Mhlontlo in the Eastern Cape (unchanged from the previous year) and Mopani District in Limpopo (improved from a disclaimed opinion in the previous year). Gariiep and Intsika Yethu in the Eastern Cape and Greater Giyani and Modimolle in Limpopo improved from an adverse to a qualified opinion in the current year.

Overall, 52 auditees received a disclaimed opinion (50 municipalities and two municipal entities), with 23 municipalities and one municipal entity moving from a disclaimed opinion in the previous year to a qualified opinion. A total of 37 auditees had the same audit opinion in the previous year, while 23 auditees have had the same audit opinion for the past five years.

The auditees with adverse and disclaimed opinions are included in the summary of provincial audit outcomes in section 2. The provinces with the most auditees in these categories are the Eastern Cape (13), Free State (nine), the Northern Cape (nine), North West (eight) and Limpopo (seven).

It is commendable that 43 auditees (13%) (37 municipalities and six municipal entities) (2012-13: 31 [10%]) have improved from a financially qualified audit opinion to a financially unqualified audit opinion with findings.

As shown in table 1 in section 2, the financial statements of almost 11% of the auditees that had received a financially qualified audit opinion in the previous year were again qualified (37 auditees).

A total of 12 auditees (4%) (nine municipalities and three municipal entities) regressed from a financially unqualified audit opinion to a financially qualified audit opinion. These auditees include four district municipalities (one each in the Free State, Gauteng, KwaZulu-Natal and Mpumalanga) and five local municipalities (one in the Eastern Cape, one in KwaZulu-Natal and three in the Northern Cape).

Overall, 14 district municipalities (32%) received qualified, adverse or disclaimed opinions and two metros (25%) (Buffalo City Metro and Nelson Mandela Bay Metro) received a qualified opinion.

Figure 4: Municipal budgets

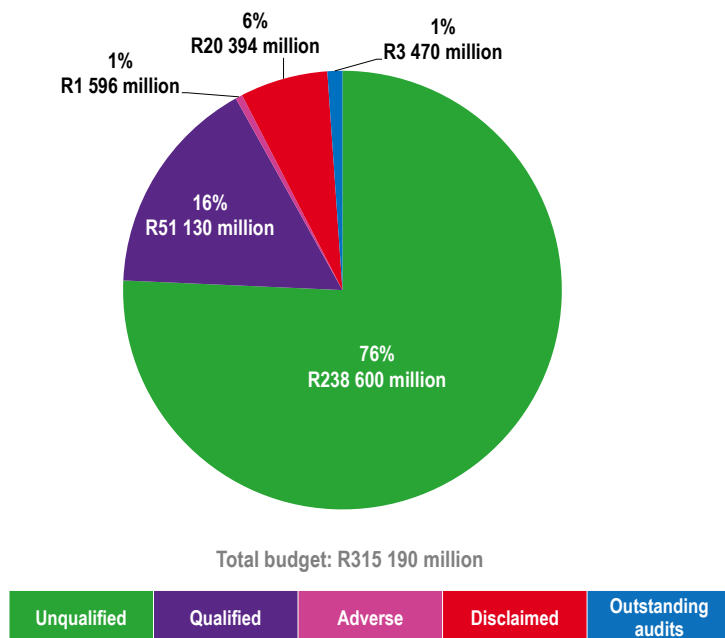


Table 1: Status of financial statements

Province	Financially unqualified auditees <u>before</u> correction of material misstatements		Financially unqualified auditees <u>after</u> correction of material misstatements	
	Number	Movement since 2012-13	Number	Movement since 2012-13
Eastern Cape	6 (11%)	⬆️	23 (41%)	⬆️
Free State	1 (4%)	⬆️	12 (44%)	⬆️
Gauteng	15 (47%)	⬆️	29 (91%)	⬆️
KwaZulu-Natal	27 (38%)	⬆️	61 (85%)	⬆️
Limpopo	1 (3%)	⬆️	15 (47%)	⬆️
Mpumalanga	4 (20%)	⬆️	8 (40%)	⬆️
Northern Cape	5 (17%)	⬆️	10 (34%)	⬆️
North West	2 (8%)	⬆️	8 (32%)	⬆️
Western Cape	23 (72%)	⬆️	32 (100%)	⬆️

Figure 4 illustrates that the 120 municipalities with qualified, adverse or disclaimed opinions received 23% of the total budget allocated to municipalities.

Table 1 in this section shows that the Northern Cape, North West and Mpumalanga had the lowest number of auditees with financially unqualified audit opinions, while the Western Cape (100%), Gauteng (91%) and KwaZulu-Natal (85%) had the most.

The quality of the financial statements submitted for auditing

While almost all auditees submitted their financial statements for auditing on time, figure 2 shows that only 84 (26%) submitted financial statements that did not have material misstatements. Overall, there has been an improvement in this regard since the previous year.

Figure 3 indicates that 114 auditees (35%) received a financially unqualified audit opinion only because they corrected all the misstatements we had identified during the audit. Only 26% of the auditees would have received an unqualified audit opinion had we not identified the misstatements and allowed management to make the corrections.

The second column of table 1 shows the low percentage of auditees in each province that would have received unqualified audit opinions had corrections not been made. It also shows that there has been an improvement in the quality of the submitted financial statements in KwaZulu-Natal, the Northern Cape and the Western Cape. The poorest sets of financial statements submitted for auditing came from Limpopo, the Free State, North West and the Eastern Cape.

Figure 3 shows that there was a notable difference in the quality of the financial statements submitted by municipalities and municipal entities. There were 26 municipal entities (46%) whose financial statements required no material corrections, while only 58 municipalities (22%) submitted financial statements that required no material adjustments.

We report the poor quality of the financial statements we receive in the audit reports of some auditees as a material compliance finding, as it also constitutes non-compliance with the MFMA (refer to section 3.2 for more details in this regard). The finding is only reported for auditees subject to the MFMA and if the financial statements we received for auditing included material misstatements that could have been prevented or detected if the auditee had an effective internal control system. We do not report a finding if the misstatement resulted from an isolated incident or if it relates to the disclosure of unauthorised, irregular or fruitless and wasteful expenditure identified after the financial statements had been submitted. An additional five municipalities and two municipal entities would have received a clean audit outcome had it not been for this particular compliance finding.

The most common areas in which auditees made corrections to achieve unqualified audit opinions relate to property, infrastructure and equipment (20%), contingent liabilities and commitments (16%), irregular expenditure – SCM (15%), expenditure (13%), receivables (12%) and revenue (10%).

The 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. Furthermore, it places undue pressure on legislated deadlines and audit fees.

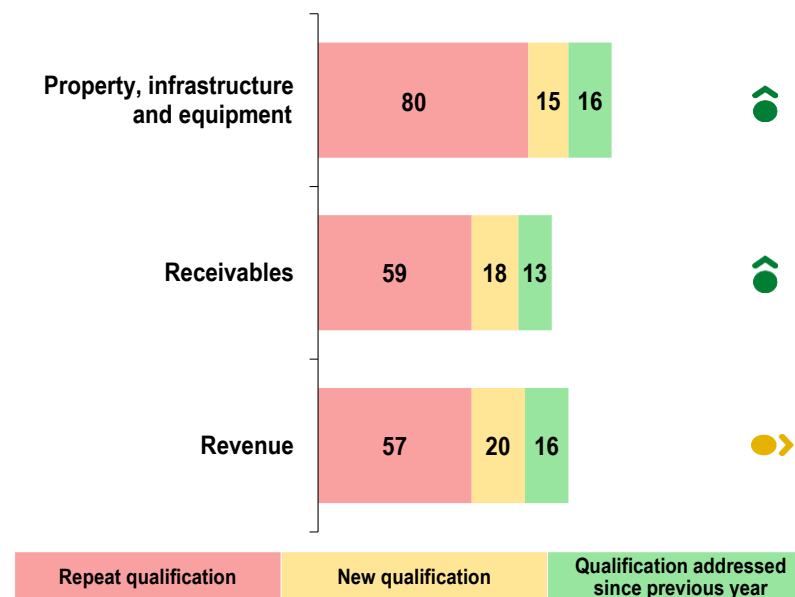
A total of 268 auditees (82%) were assisted by consultants with the preparation of their financial statements and related financial reporting services. Refer to section 5.2 for more details in this regard.

Financial statement areas qualified (uncorrected material misstatements)

Although we reported the material misstatements to management for correction, 127 auditees (2012-13: 168) could not make the necessary corrections to their financial statements, which resulted in qualified, adverse or disclaimed audit opinions. The major reason for not making the corrections was the unavailability of, or incomplete, information or documentation to determine the correct amounts to be reflected in the financial statements.

Figure 5 indicates the three most common financial statement qualification areas of the 120 municipalities and seven municipal entities whose financial statements were qualified, and the progress made in addressing these areas since the previous year.

Figure 5: Three most common financial statement qualification areas












It is encouraging that the over 100 auditees that were qualified in 2012-13 for materially misstating the irregular expenditure incurred in their financial statements have decreased by over 26% in the current year to 74.

The most common qualification areas are discussed in more detail below.

Property, infrastructure and equipment (92 municipalities and three municipal entities)

The number of municipalities qualified in this area decreased by 20%, with 13 municipalities being qualified for the first time in this area this year. The most notable improvements were in Limpopo, KwaZulu-Natal and the Eastern Cape where the number of municipalities qualified in this area decreased by at least 30% when compared to the previous year, as can be seen below.

Table 2: Movement in number of auditees qualified on property, infrastructure and equipment

Province	2013-14	2012-13	Percentage movement	Movement
Eastern Cape	18	26	31%	
Free State	11	15	27%	
Gauteng	2	0	(200%)	
KwaZulu-Natal	5	8	38%	
Limpopo	15	25	40%	
Mpumalanga	10	10	0%	
Northern Cape	17	18	6%	
North West	14	13	(8%)	
Western Cape	0	0	0%	

The main reason for these qualifications at municipalities was that the value of assets recorded in the financial statements was incorrect or we could not confirm the value at which the asset had been recorded (90 municipalities). A total of 74 municipalities did not include all the assets they own in an asset register or we could not obtain sufficient evidence that all the assets had been included. At 60 municipalities, the value of assets that did not exist or whose existence we could not confirm was included in the financial statements.

This was as a result of incorrect or incomplete accounting records (e.g. asset registers) as well as inadequate or missing supporting documentation. Missing or supporting documents that could not be submitted at 80 municipalities and incorrect accounting records at 54 municipalities contributed to the qualifications.

Receivables (76 municipalities and one municipal entity)

The number of municipalities in this area decreased by 8%, with 17 municipalities being qualified for the first time in this area this year. The most notable improvements were in Mpumalanga and Limpopo where the number of municipalities qualified in this area decreased by 43% and 38%, respectively, compared to the previous year.

The main reason for these qualifications at municipalities was that the value of receivables (debtors) disclosed in the financial statements was incorrect or we could not confirm the value at which the receivable (debtor) had been recorded (73 municipalities). The financial statements of 49 municipalities did not include all of their debtors or we could not obtain sufficient evidence that all the debtors had been included. At 52 municipalities, we could not confirm the value or existence of debtors.

This was as a result of incorrect or incomplete accounting records as well as inadequate or missing supporting documentation. Missing or supporting documents that could not be submitted at 65 municipalities and incorrect accounting records at 36 municipalities contributed to the qualifications.

Revenue (76 municipalities and one municipal entity)

The number of municipalities qualified in this area decreased by 4%, with 20 municipalities being qualified for the first time in this area this year. The most notable improvements were in Limpopo and North West where the number of municipalities qualified in this area decreased by 23% and 13%, respectively, when compared to the previous year.

The main reason for these qualifications was that municipalities did not reflect all the revenue earned in their financial statements or we could not obtain sufficient

evidence that all revenue had been included (73 municipalities). At 62 municipalities, we could not confirm that the revenue amounts had been correctly calculated. The revenue amounts at 54 municipalities were also qualified because we could not obtain sufficient evidence that the recorded revenue was based on transactions that had taken place.

This was as a result of incorrect or incomplete accounting records as well as inadequate or missing supporting documentation. Missing or supporting documents that could not be submitted at 63 municipalities and incorrect accounting records at 40 municipalities contributed to the qualifications.

Recommendations

Auditees that received qualified, adverse or disclaimed opinions and those that submitted financial statements of a poor quality for auditing should strengthen their processes and controls to create and sustain a control environment that supports reliable reporting. These auditees should implement at least the following key controls and best practices in place at other auditees:

- **Proper record keeping** and the availability of the evidence that supports all amounts and disclosures in the financial statements are key, as most of the qualifications were as a result of missing supporting documentation or documentation that could not be submitted. Records and other evidence should be maintained throughout the year. CFOs should determine whether such evidence is available as part of their review and sign-off of the financial statements. Internal audit units can also provide support in this regard.
- Controls should be in place to ensure that transactions are processed in an accurate, complete and timely manner. This will reduce errors and omissions in financial reports. **Daily disciplines**, such as reviewing and approval processes and reconciliations of key accounts, should be normal practice. This will enable officials to prepare credible monthly management accounts and meaningful analyses and forecasts. It will also allow auditees to test the robustness of their processes before the financial statements are submitted for auditing at year-end, while errors and omissions will be identified and corrected at an earlier stage.
- **Action plans** should be implemented and monitored. Auditees need to prepare audit action plans based on the audit findings, root causes and recommendations provided by us as well as internal audit units, audit committees and governance structures. The plan should include definite actions to address findings and assign timelines and responsibilities. Progress should be reported to the audit committee.
- **Capacity** constraints in finance units need to be addressed, as detailed in section 5.1. Vacancies within the unit and in the CFO position should be filled and auditees should actively work towards ensuring that all finance officials have the required minimum competencies. In addition, officials should receive

training and regular updates on the Generally Recognised Accounting Practice (GRAP) framework.

- Treasuries should intensify **support** to auditees and focus on sustainable solutions, such as training, guidance, standard operating procedures and knowledge-sharing forums. The support of the provincial treasuries has had a positive impact in the Western Cape and Gauteng.

Figure 1: Three-year trend – compliance with key legislation

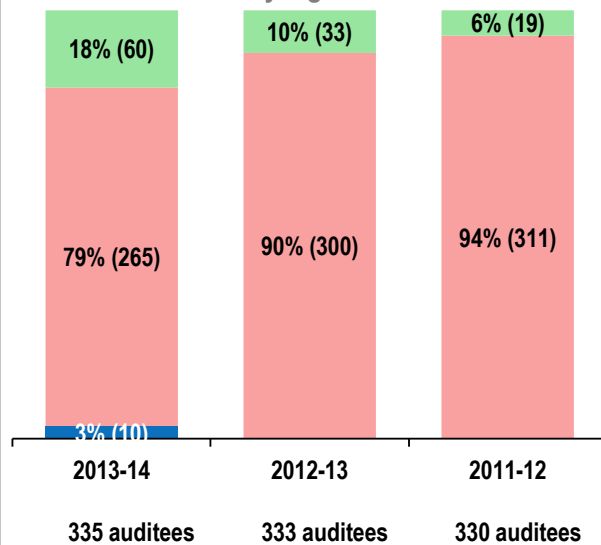


Figure 2: Compliance with key legislation per auditee type

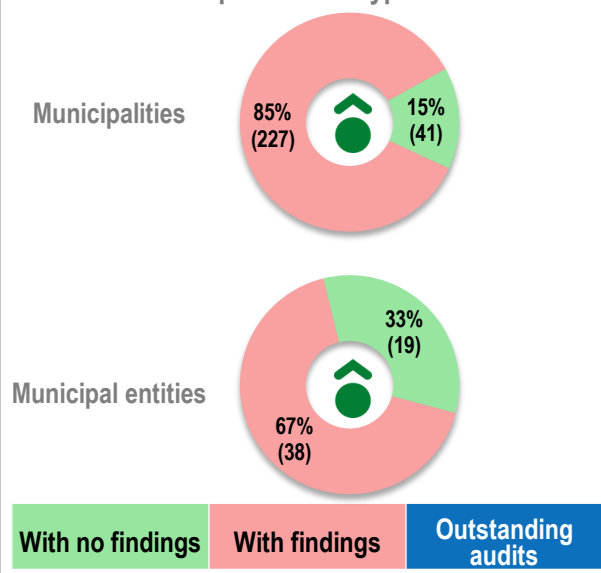


Figure 3: Most auditees did not comply with key legislation in the following areas

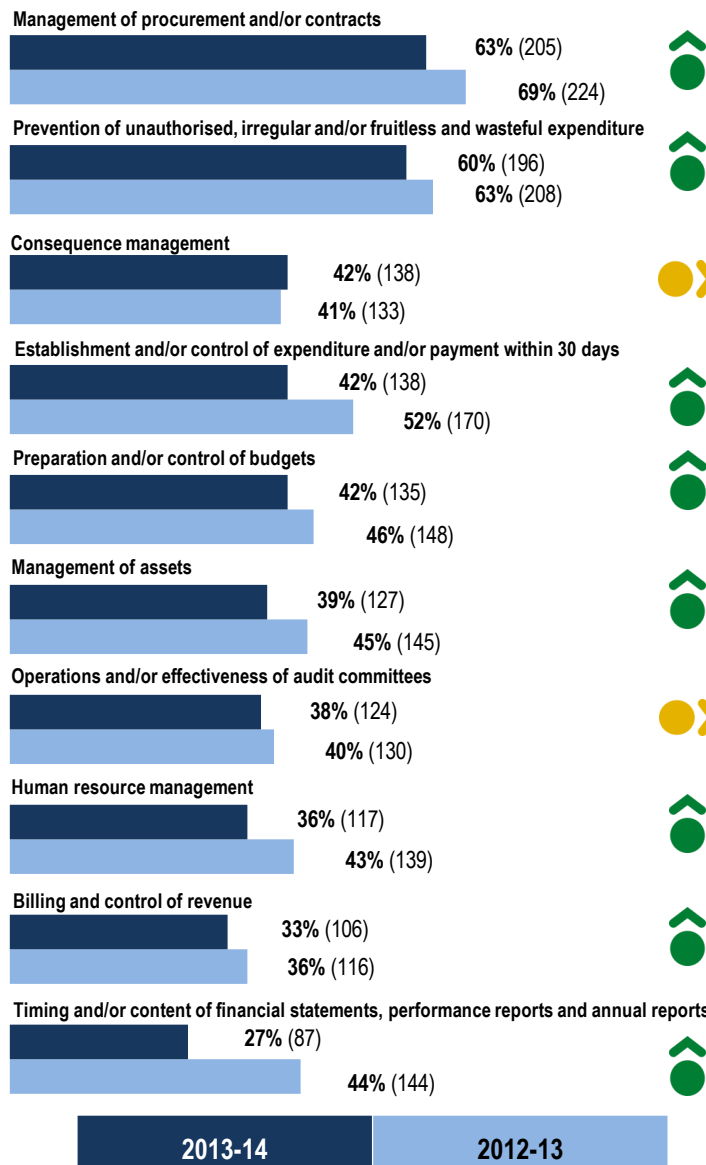


Table 1: Status of compliance with key legislation

Province	Auditees with no findings on compliance	Movement
Eastern Cape	5%	↑
Free State	0%	All auditees had findings
Gauteng	44%	↑
KwaZulu-Natal	29%	↑
Limpopo	0%	All auditees had findings
Mpumalanga	10%	→
Northern Cape	7%	→
North West	0%	All auditees had findings
Western Cape	56%	↑

3.2 Compliance with key legislation

We continue to annually audit and report on compliance by auditees with key legislation applicable to financial and performance management and reporting as well as related matters, also shortened to *key legislation* in the rest of the report.

We focused on the following areas in our compliance audits: ■ the quality of annual financial statements submitted for auditing ■ asset and liability management ■ audit committees and internal audit units ■ budget management ■ expenditure management ■ unauthorised, irregular as well as fruitless and wasteful expenditure ■ consequence management ■ revenue management ■ strategic planning and performance management ■ annual financial statements and annual report ■ transfer of funds and conditional grants ■ procurement and contract management (in other words, SCM) ■ HR management and compensation.

In our audit reports, we reported those findings arising from the audits that were material enough to be brought to the attention of auditee management, municipal councils, boards of municipal entities as well as oversight bodies and the public.

Status of, and trends in, compliance with key legislation

Figures 1 and 2 show the number and type of auditees that had material compliance findings over the past three years, while table 1 indicates the progress made by the different provinces in adhering to legislation.

While the three-year trend reflects an improvement, auditees' non-compliance with key legislation remained at a high level. The number of auditees with findings decreased at all auditee types, most notably at district municipalities (from 38 to 31) and local municipalities (from 209 to 190). Two of the metros did not have any non-compliance findings, which is the same number as in the previous year.

Only 28 out of 35 auditees retained their prior year status of no material findings on compliance with key legislation. However, it is encouraging that auditees achieving this status increased from 33 to 60, largely due to such auditees now numbering 14 in Gauteng, 21 in KwaZulu-Natal and 18 in the Western Cape.

Findings on compliance with legislation

Figure 3 shows the non-compliance areas with the most material findings in the current year and the progress made in addressing these since the previous year. The reduction in findings from 2012-13 in all but one area could indicate that these areas are receiving more attention.

In the past three years, material misstatements in submitted financial statements, SCM and the prevention of unauthorised, irregular as well as fruitless and wasteful

expenditure have consistently been the areas with the most non-compliance findings. The most common findings across all areas include the following:

- There were material misstatements or limitations in the financial statements submitted for auditing. (Please note that this finding was only reported in certain circumstances, as explained in section 3.1.)
- Auditees did not comply with SCM regulations.
- Auditees did not prevent unauthorised, irregular as well as fruitless and wasteful expenditure.
- The internal controls relating to revenue were ineffective at 73 auditees (22%), while management, accounting and information systems that account for revenue and receivables were inadequate at 55 auditees (17%). The impact of this is clear in the qualifications of revenue and receivables and the weaknesses in revenue management, as detailed in sections 3.1 and 3.3, respectively.
- Even though legislation is clear on the consequences for non-compliance with legislation and the steps to be taken to deal with such transgressions, 138 auditees (42%) did not comply with these requirements.
- A total of 121 auditees (37%) did not pay their creditors within 30 days or an agreed-upon period (also refer to section 3.3 which discusses financial health).
- Countrywide, 104 auditees (32%) overspent their approved budgets in the current and previous years or their spending was not within the approved limits of the different votes in the budgets. The resultant unauthorised expenditure is detailed further on this section, while section 3.3 deals with the weaknesses in budget management.
- Controls over assets and asset registers were not effective at 111 auditees (34%), while management, accounting and information systems that account for the assets were inadequate at 73 auditees (22%). The impact of the non-compliance can be seen in the qualifications of assets and the weaknesses in the delivery of roads infrastructure, as further discussed in sections 3.1 and 4.2, respectively.

We provide further details of compliance findings related to HR management in section 5.1 and audit committees in section 7.5. Sections 3.2.1 to 3.2.3 that follow provide more information on SCM and unauthorised, irregular as well as fruitless and wasteful expenditure, followed by recommendations and best practices in section 3.2.4.

Annexure 1 also details the auditees with material compliance findings and indicates whether these findings had recurred.

Figure 1: Status of supply chain management

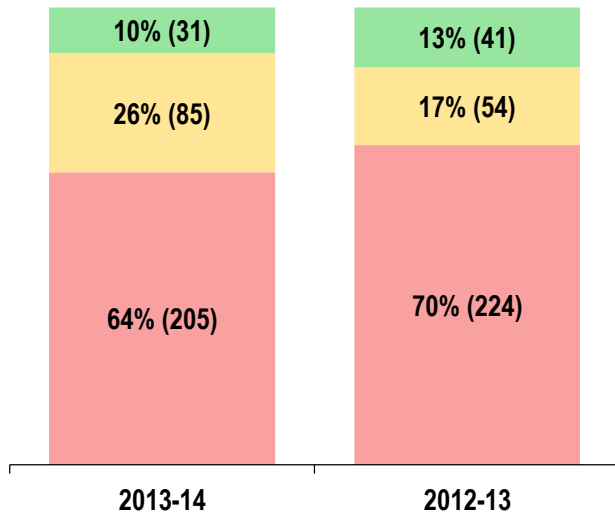


Figure 3: Findings on supply chain management

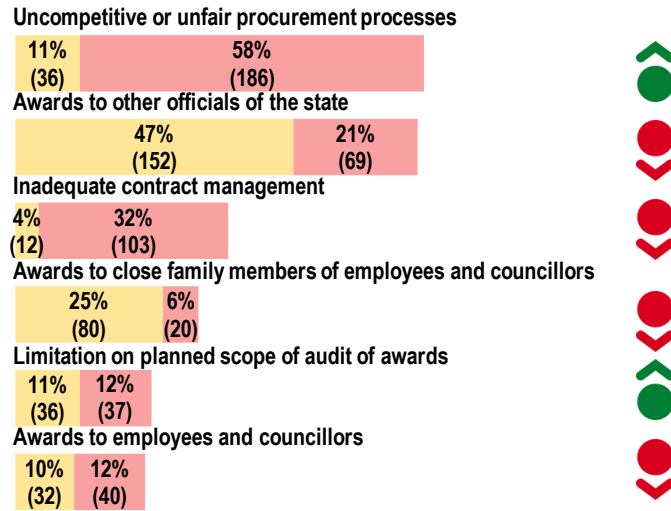


Table 1: Progress made with regard to supply chain management by provinces

Province	Auditees with no findings on supply chain management	Movement
Eastern Cape	5%	↓
Free State	4%	→
Gauteng	23%	↓
KwaZulu-Natal	10%	↓
Limpopo	9%	↑
Mpumalanga	10%	↑
Northern Cape	3%	→
North West	4%	→
Western Cape	19%	↑

Figure 2: Supply chain management findings per auditee type

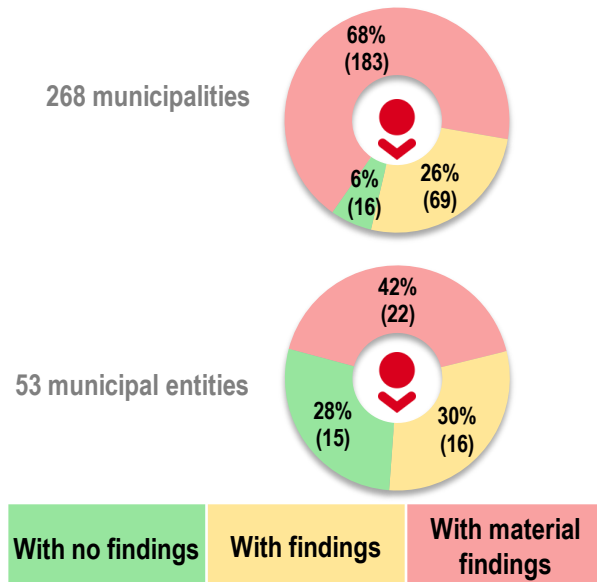
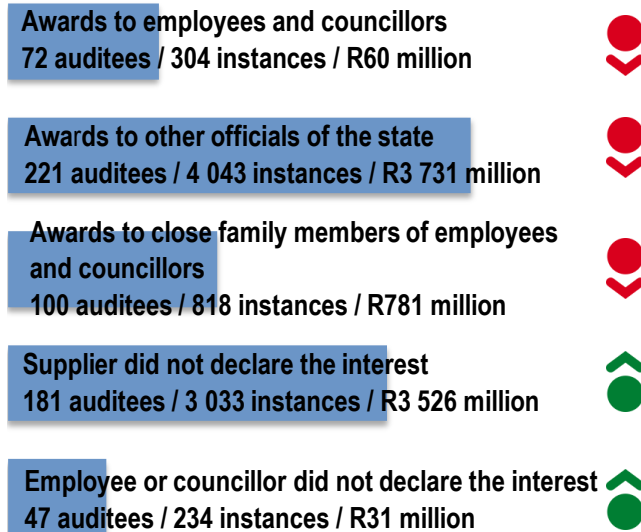


Figure 4: Extent of awards to employees, councillors, close family members and other officials of the state; and declarations by suppliers and employees/councillors



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

Weaknesses in SCM remain a major obstacle to local government’s ambition for a better life for citizens. We name poor SCM practices as a reason for capital budgets and grants being underspent in sections 3.3 and 3.4. A total of 99% of the irregular expenditure was caused by non-compliance with SCM legislation, while it was one of the most common areas in which auditees – 63% of them – had material non-compliance findings, as highlighted in section 3.2.

As part of our audits of SCM, we tested 7 374 contracts (with an approximate value of R42 675 million) and 15 189 quotations (with an approximate value of R799 million), also referred to as *awards* in the rest of the report. We did not audit SCM at four municipal entities, due to the insignificant amount they incurred on procurement.

We tested whether the prescribed procurement processes had been followed to ensure that all suppliers were given equal opportunity to compete and that some suppliers were not favoured above others. We also focused on contract management, as shortcomings in this area can result in delays, wastage as well as fruitless and wasteful expenditure, which in turn have a direct impact on service delivery. We further assessed the financial interests of employees and councillors of the auditee and their close family members in suppliers to the auditee.

We reported all the findings from the audits to the management of auditees in a management report, while only the material non-compliance findings were reported in their audit reports.

Figure 1 shows the number of auditees that had findings on SCM and those where we reported material non-compliance findings in the audit report in the current and previous years. There has been an overall regression since the previous year, as the number of auditees with audit findings has increased from 278 to 290. The 8% overall reduction in the number of auditees with material findings is a definite sign that auditees are paying closer attention to SCM, but it remains concerning that more than two-thirds of the municipalities and over 40% of the municipal entities had material SCM findings, as shown in figure 2.

Table 1 indicates that the number of auditees without SCM findings increased in three of the provinces, with the auditees in the Western Cape and Gauteng performing the best. The auditees in the Eastern Cape, the Free State, the Northern Cape and North West performed the worst, as they either remained unchanged or regressed from the previous year.

Figure 3 shows the SCM areas in which auditees had findings, the number of auditees where the findings were material enough to be reported in the audit report, and the progress made in some SCM areas.

The remainder of this section further discusses the outcomes of our audits in the different areas, while annexure 1 lists the auditees with SCM findings and indicates whether these findings had recurred.

Limitations on planned scope of audit of awards

We could not audit awards with a value of R1 344 million at 73 auditees (23%), as they could not provide us with evidence that awards had been made in accordance with the requirements of SCM legislation. This was because the documentation either did not exist or could not be retrieved as a result of poor document management. We had encountered similar limitations at 42 of these 73 auditees (58%) in the previous year.

The table below shows the extent of limitations in the different provinces.

Table 2: Extent of limitations on planned audits

Province	2013-14			2012-13			Movement (number of auditees)
	Auditees	Percentage of auditees reported on	Amount R million	Auditees	Percentage of auditees reported on	Amount R million	
Eastern Cape	20	36%	341	16	29%	1 183	↓
Free State	10	37%	126	14	52%	295	↑
Gauteng	4	13%	85	3	10%	3	↓
KwaZulu-Natal	9	13%	192	12	17%	274	↑
Limpopo	8	25%	86	13	42%	216	↑
Mpumalanga	4	20%	167	8	40%	78	↑
Northern Cape	7	24%	35	17	59%	118	↑
North West	9	36%	290	14	56%	667	↑
Western Cape	2	6%	21	1	3%	0	↓
Total	73	23%	1 344	98	31%	2 834	

The movement in limitations is determined by the number of auditees, as amounts can be influenced by large contracts falling within the limitations.

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 auditees 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 SCM non-compliance, irregularities and possible fraud.
- Poor record management created an environment in which it was easy to commit and conceal possible improper or illegal behaviour.

Awards to employees and councillors or other state officials

SCM regulation 44 prohibits awards of contracts and quotations to employees, councillors or other state officials, or entities owned or managed by them, if they are in the service of the auditee or if they are in the service of any other state institution. Such expenditure is also considered irregular. During our audits, we identified such prohibited awards and also tested whether the legislated requirements with regard to declarations of interest had been adhered to.

Figure 4 shows that 304 awards were made to suppliers in which employees and councillors had an interest at 72 auditees (22%) to the value of R60 million. This is a regression from the previous year when awards to employees and councillors were identified at only 55 auditees. A total of 189 employees, 21 councillors and 198 suppliers benefitted from these prohibited practices. This transgression was identified across all the provinces as follows:

- Eastern Cape – 15 municipalities, including Nelson Mandela Bay Metro and Buffalo City Metro
- Free State – 10 municipalities and one municipal entity
- Gauteng – three municipalities (including Ekurhuleni Metro and Tshwane Metro) and one municipal entity
- KwaZulu-Natal – 13 municipalities (including eThekweni Metro) and one municipal entity
- Limpopo – five municipalities
- Mpumalanga – nine municipalities

- North West – eight municipalities
- Northern Cape – four municipalities
- Western Cape – two municipalities

We are concerned about the awards to employees and councillors, as these could have been prevented or detected by implementing basic controls, such as employees, councillors and suppliers submitting declarations of interest and checking auditees' personnel records and information at the Companies and Intellectual Property Commission.

At 47 of the 72 auditees, employees and councillors (12 councillors and two mayors) did not declare their interest in awards with a value of R31 million. Suppliers did not declare their interests at 46 auditees. This means that awards were still made at the remainder of the auditees despite the interest having been declared. These poor controls could indicate that auditees are not taking this requirement seriously.

The possibility of undue influence can also not be disregarded, especially if the persons could have influenced the procurement processes for these awards, such as councillors, municipal managers and SCM officials, which could have created opportunities for irregularities.

Figure 4 further shows that 4 043 awards were made to suppliers in which other state officials had an interest at 221 auditees (69%) to the value of R3 731 million. This is a significant increase from 2012-13 when 1 617 awards to the value of R445 million were made to other state officials at 178 auditees. As auditees did not have access to information on persons employed at other state institutions, they could only rely on the declarations provided by suppliers. Suppliers did not declare the interest of state officials in 2 446 instances at 193 auditees with a value of R2 901 million.

It is of concern that this practice is increasing, as we have been reporting on this matter for a number of years and recommending that auditees implement proactive processes and insist on declarations.

The failure by suppliers to declare the interest of employees, councillors and other state officials constitutes a fraudulent act and should be investigated and dealt with in accordance with legislation.

Awards to close family members of employees and councillors

Awards to close family members of persons in the service of the state, whether at the auditee or another state institution, are not prohibited. However, such awards of more than R2 000 must be disclosed in the financial statements of the auditee for the sake of transparency and as required by SCM regulation 45. A close family member is a spouse, child or parent of a person in the service of the state.

During our audits, we identified awards to close family members and also tested whether the financial statement disclosure was made and whether the legislated requirements with regard to declarations of interest were adhered to.

Figure 4 shows that awards were made to close family members of employees and councillors at 100 auditees (31%) to the value of R781 million. These included 22 councillors, five mayors, three accounting officers, four SCM officials and four senior managers. This is a significant increase from 2012-13 when 292 awards to the value of R115 million were made to close family members at 45 auditees. This increase also shows that auditees are not responding quickly enough to our recommendations in this regard.

Of these auditees, 31 (31%) failed to disclose the awards in their annual financial statements.

The employees and councillors (seven councillors and four mayors) at 30 auditees did not declare the interest of their close family members to the value of R21 million, while suppliers did not declare this interest at 61 auditees (R610 million).

Uncompetitive or unfair procurement processes

The principles of a fair, equitable, transparent, competitive and cost-effective supply chain process are fundamental to the procurement practices of the public sector – it is enshrined in the Constitution and prescribed in the MFMA and its SCM regulations. The MFMA and these regulations define what processes should be followed to achieve the constitutional principles, the level of flexibility available, and the documentation requirements.

Overall, there has been a reduction from the previous year in the number of auditees with findings on uncompetitive or unfair procurement processes. As shown in figure 3, however, the proportion of material findings remained high (186 auditees [58%]). These findings were also the main cause of the irregular expenditure of R11 351 million incurred as a result of non-compliance with SCM legislation.

The most common findings were similar to those in the previous year, and included the following:

- **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 143 auditees (45%).
- **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 68 auditees (21%).

The impact of these two types of findings could have been that goods and services were not procured at the best price and quality, and that businesses might not have been provided with an equal opportunity to benefit from government business.

Fundamental to a fair and competitive process is the opportunity given to businesses to compete for providing goods and services to government. If bids and quotations are not invited, the process is uncompetitive and unfair. Not inviting bids and quotations is only acceptable under certain circumstances; for example, when there is only one supplier that can produce the goods or services.

- Procurement from suppliers who did not provide evidence that their **tax affairs** were in order – reported at 80 auditees (25%). Consequently, businesses that did not pay taxes could have been awarded government business. It could also have resulted in unfairness, as some businesses might have been excluded from tender processes if they could not produce a certificate; while others were not.
- The **preference point** system was not applied when selecting suppliers – reported at 48 auditees (15%). This meant that the principles of equity and preference as determined in the Constitution and the Preferential Procurement Policy Framework Act were not applied.
- In addition to the 181 auditees where **declarations of interest** were not submitted by suppliers or the declarations were determined to be false, as discussed earlier on in this section, declarations of interest were also not submitted as part of the procurement processes at a further 22 auditees (7%) – thus reported at a total of 203 auditees (63%). If a declaration is not submitted, an auditee cannot determine whether a contract or quotation can be awarded to the supplier. The fact that contracts and quotations were awarded without these declarations clearly indicates that auditees did not take the prohibition of awards to suppliers in which employees, councillors and other state officials had an interest seriously.

Inadequate contract management

Overall, the findings on contract management have decreased from 121 auditees (38%) last year to 115 auditees (34%) this year. As shown in figure 2, however, the proportion of material findings remained high (103 auditees [32%]).

The following were the most common findings:

- **Construction contracts were not registered** with the Construction Industry Development Board within 21 working days – reported at 52 auditees (16%).
- There were no, or inadequate, **contract performance measures** and monitoring – reported at 46 auditees (14%).
- The performance of contractors was **not monitored on a monthly basis** – reported at 42 auditees (13%).
- Contracts **were amended or extended** without the reasons being tabled in the council – reported at 33 auditees (10%).

The weaknesses in SCM require immediate and focused action to ensure that the principles of fairness, transparency, completeness, equity and cost-effectiveness in procurement processes receive the necessary attention. It will also address the very high amounts of irregular expenditure incurred annually.

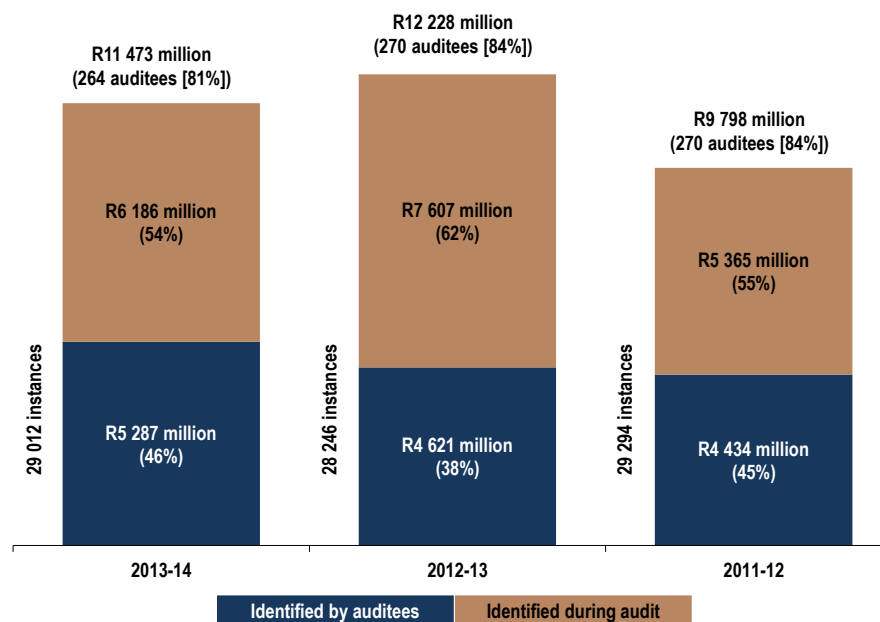
Irregular expenditure

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 a measure of an auditee’s ability to comply with legislation relating to expenditure and procurement management.

The MFMA requires municipal managers to take all reasonable steps to prevent irregular expenditure. If there is a persistent disregard for strengthening this control, opportunities may be inadvertently created for the commission of fraudulent transactions. Auditees should have processes in place to detect non-compliance with legislation that results in irregular expenditure and to disclose the amounts in the financial statements. Irregular expenditure is reported when it is identified – even if the expenditure was from a previous year.

Trends in irregular expenditure

Figure 5: Three-year trend in irregular expenditure



All types of auditees incurred irregular expenditure, including all the metros and 81% of the district municipalities. Irregular expenditure was common in all the provinces.

Figure 5 shows a slight decrease of 6% (R755 million) from the previous year in the amount of irregular expenditure incurred as well as in the number of auditees incurring such expenditure. However, the number of instances has increased marginally.

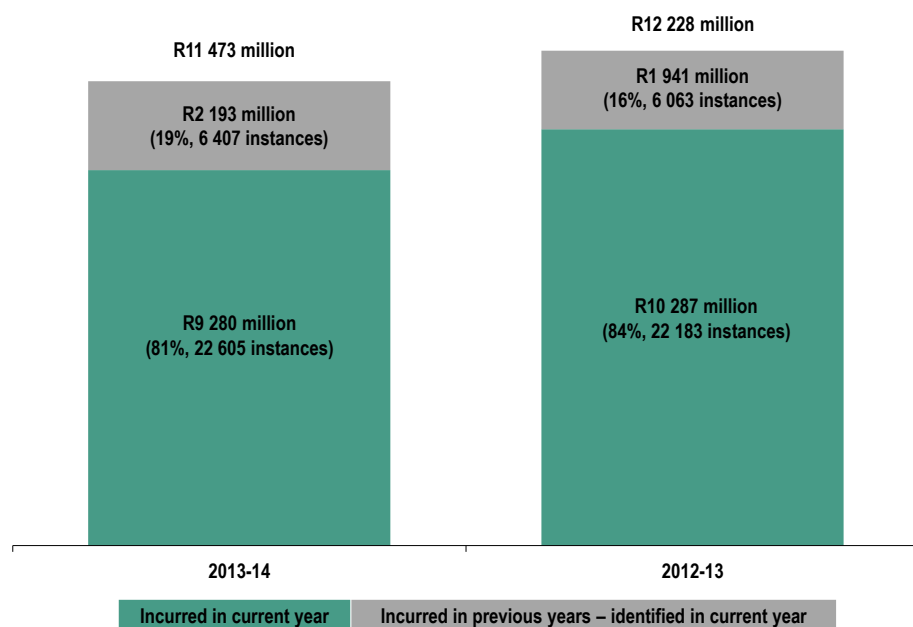
A total of 240 (91%) of the 264 auditees also incurred irregular expenditure in the previous year, of which 222 had incurred such expenditure for the past three years. These auditees include all the metros and 31 district municipalities (72%). More than 70% of the auditees in the Eastern Cape, the Free State, Limpopo, the Northern Cape and North West incurred irregular expenditure in the past three years, with a high of 93% in the Free State and 91% in Limpopo.

The following auditees were the main contributors (26%) to irregular expenditure in 2013-14:

- Nelson Mandela Bay Metro (EC) – R1 052 million (2012-13: R1 844 million)
- Matlosana (NW) – R630 million (2012-13: R399 million)
- uMkhanyakude District (KZN) – R556 million (2012-13: R249 million)
- Buffalo City Metro (EC) – R409 million (2012-13: R332 million)
- King Sabata Dalindyebo (EC) – R367 million (2012-13: R201 million)

A total of 59 auditees disclosed in the financial statements that they had incurred irregular expenditure, but the full amount was not known as they still had to investigate whether there was non-compliance of a similar nature in the current and previous years. This means that the amount of irregular expenditure for 2013-14 could have been higher if these investigations had been completed.

Figure 6: Previous years' irregular expenditure identified in the current year



We analysed the timing of the irregularities to determine whether the irregular expenditure could be the result of prior year irregularities being identified and reported on in the current year. Figure 6 shows that 19% of the irregular expenditure amount and 22% of the instances were as a result of non-compliance in previous years.

Nature of the irregular expenditure

The following were the main areas of SCM non-compliance as disclosed by the auditees in their financial statements, with an indication of the estimated value of the irregular expenditure:

- Procurement without a competitive bidding or quotation process – R4 397 million (39%)
- Non-compliance with procurement process requirements – R5 981 million (53%)
- Non-compliance with legislation on contract management – R972 million (9%)

We provide more details of the outcome of our audits on SCM earlier on in this section.

A total of R2 082 million of the irregular expenditure related to some auditees reviewing the extent of their prior year irregular expenditure and fully recognising it to address a qualification of the irregular expenditure disclosed in their financial statements in the previous year. Most of these auditees (22%) were from North West.

Prevention, detection and disclosure

As detailed in the previous section on compliance, inadequate steps taken by municipal managers to prevent irregular expenditure were one of the most common material non-compliance findings. We reported the non-compliance as material at 189 auditees (72%), based on them incurring irregular expenditure in the current and previous years, a recurrence of the transgressions that had caused the irregular expenditure, and our assessment that adequate controls and processes would have prevented it.

Figure 5 shows that we had identified 54% of the irregular expenditure amount during the audit process, which means that most auditees did not have adequate processes to detect and quantify the irregular expenditure. This is an improvement from the 62% in the previous year, while the number of auditees identifying their own irregular expenditure slightly regressed from 49 to 46.

The disclosure of irregular expenditure in the financial statements was materially misstated at 30 auditees (11%), and we could not obtain sufficient and appropriate audit evidence for the amounts disclosed at 44 auditees (17%). In total, these 74 auditees (28%) are an improvement from the 109 auditees (40%) in the previous year.

Lack of consequences for irregular expenditure

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.

At 113 auditees (35%) (2012-13: 115 [36%]), the municipal manager and council did not investigate the irregular expenditure of the previous year to determine if any person was liable for the expenditure. Consequently, it was not determined whether the irregularities constituted fraud or whether any money had been wasted.

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 R6 598 million (58%) of the R11 351 million in irregular expenditure relating to SCM non-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.

Annexure 1 to this report gives further details of irregular expenditure.

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3.2.2 Fruitless and wasteful expenditure

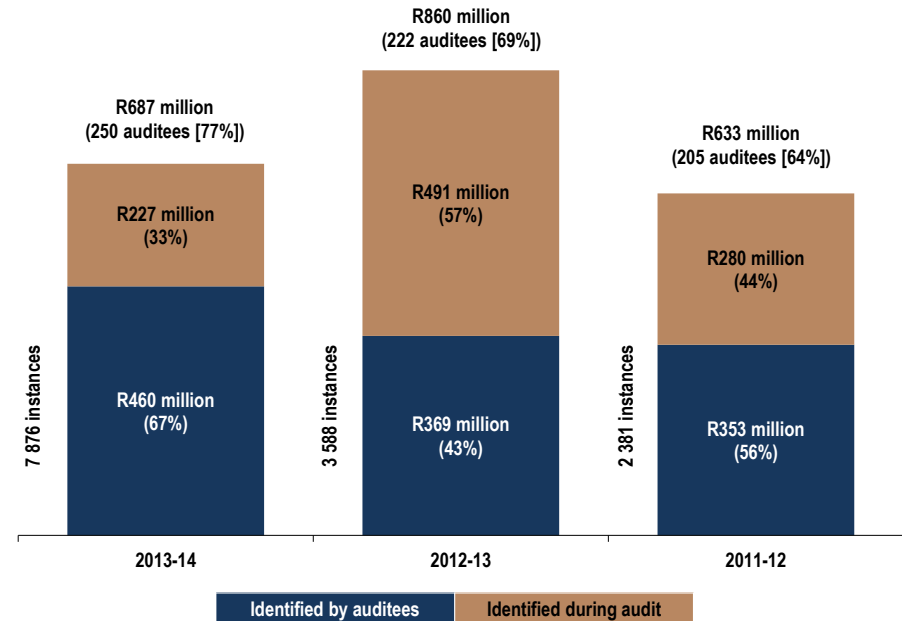
Fruitless and wasteful expenditure is expenditure that was made in vain and that could have been avoided had reasonable care been taken.

The MFMA requires municipal managers to take all reasonable steps to prevent fruitless and wasteful expenditure. Auditees should have processes in place to detect fruitless and wasteful expenditure and to disclose the amounts in the financial statements. Fruitless and wasteful expenditure is reported when it is identified – even if the expenditure was from a previous year.

The MFMA also sets out the steps that municipal managers and councils should take to investigate fruitless and wasteful expenditure to determine whether any officials are liable for the expenditure and to recover the money if liability is proven.

Trends in fruitless and wasteful expenditure

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



As shown in figure 1, 77% of the auditees incurred fruitless and wasteful expenditure. All types of auditees incurred such expenditure, including seven of the metros and 72% of the district municipalities. Fruitless and wasteful expenditure was common in all the provinces.

The figure shows a decrease in the amount of fruitless and wasteful expenditure since 2012-13, but the number of auditees has increased. A total of 198 auditees incurred fruitless and wasteful expenditure in the current and previous year, of which 165 had incurred such expenditure for the past three years. More than half of the auditees in the Eastern Cape, Free State, Limpopo, the Northern Cape and North West incurred fruitless and wasteful expenditure in the past three years, with 89% of the auditees in the Free State incurring such expenditure. All metros except Johannesburg Metro, City of Cape Town Metro and eThekweni Metro also fell within this category, as did 40% of the district municipalities.

The following auditees were the main contributors (41%) to the fruitless and wasteful expenditure in 2013-14:

- Matjhabeng (FS) – R103 million (2012-13: R76 million)
- Ngwathe (FS) – R58 million (2012-13: R21 million)

- Emalahleni (MP) – R56 million (2012-13: R12 million)
- Maluti-A-Phofung (FS) – R32 million (2012-13: R11 million)
- Umtshezi (KZN) – R29 million (2012-13: R0)

Nature of the fruitless and wasteful expenditure

Of the R687 million, 8% was incurred to prevent further fruitless and wasteful expenditure or losses. It normally relates to the cost of cancelling irregular contracts or contracts of non-performers.

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

- Interest on overdue accounts and late payments – R550 million (80%) – 210 auditees
- Penalties – R34 million (5%) – 79 auditees
- Litigation and claims – R9 million (1%) – 21 auditees
- Other (e.g. missed flights and non-refundable deposits for cancelled events and accommodation) – R94 million (14%) – 71 auditees

Prevention, detection and disclosure

As detailed in the previous section on compliance, inadequate steps taken by municipal managers to prevent fruitless and wasteful expenditure were one of the most common material non-compliance findings. We reported the non-compliance as material at 143 auditees (57%), based on them incurring fruitless and wasteful expenditure in the current and previous years, a recurrence of the action that had caused the fruitless and wasteful expenditure, and our assessment that adequate controls and processes would have prevented it.

Figure 1 further shows that we had identified 33% of the fruitless and wasteful expenditure amount during the audit process, which means that some auditees did not have adequate processes to detect and quantify the fruitless and wasteful expenditure. However, this is a significant improvement from the 57% in the previous year, with the number of auditees identifying their own fruitless and wasteful expenditure improving from 127 (57%) to 167 (67%).

Lack of consequences for fruitless and wasteful expenditure

At 94 auditees (29%) (2012-13: 83 [26%]), the municipal manager and council did not investigate the fruitless and wasteful expenditure of previous years to determine if any person was liable for the expenditure.

Annexure 1 to this report gives further details of fruitless and wasteful expenditure.

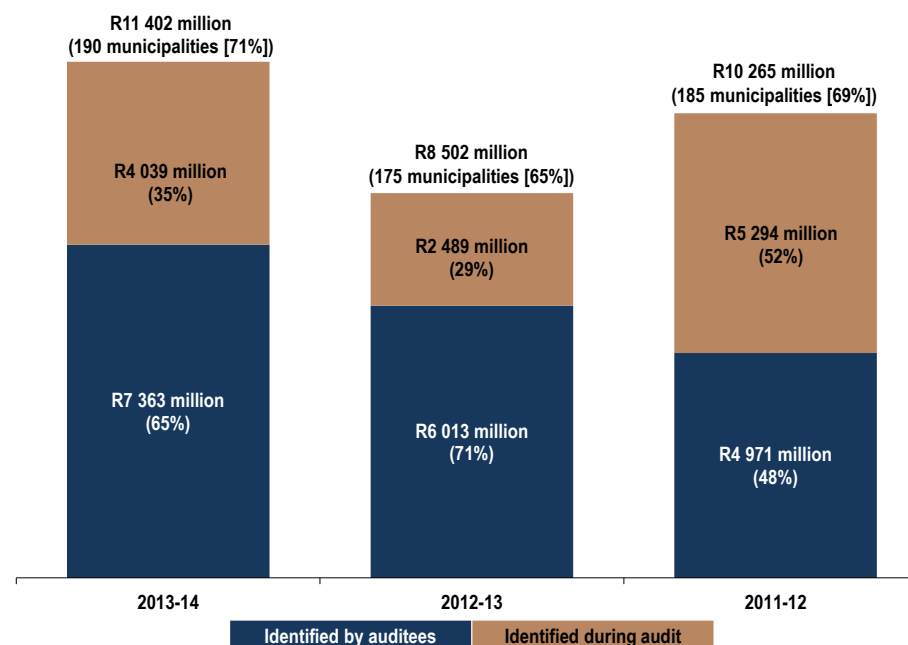
3.2.3 Unauthorised expenditure

Unauthorised expenditure is expenditure that had not been spent by municipalities in accordance with the budget approved by the council or the conditions of a grant.

The MFMA requires municipal managers to take all reasonable steps to prevent unauthorised expenditure. Auditees should have processes in place to identify any unauthorised expenditure incurred and to disclose the amounts in the financial statements. The MFMA also includes the steps that municipal managers and councils should take to investigate unauthorised expenditure to determine whether any officials are liable for the expenditure and to recover the money if liability is proven.

Trends in unauthorised expenditure

Figure 1: Three-year trend in unauthorised expenditure



As shown in figure 1, over 70% of the municipalities incurred unauthorised expenditure, including four of the metros and 51% of the district municipalities. Unauthorised expenditure was common in all the provinces.

The three-year trend in unauthorised expenditure shows the amount increasing by 34% (R2 900 million) this year compared to last year and the number of auditees incurring such expenditure increasing by 9%. The amount of unauthorised expenditure increased in all the provinces except the Northern Cape, while the number of auditees incurring unauthorised expenditure increased in all the provinces except the Free State and the Western Cape.

A total of 151 (79%) of the 190 auditees also incurred unauthorised expenditure in the previous year, of which 128 had incurred such expenditure for the past three years. These municipalities include Nelson Mandela Bay Metro, Tshwane Metro and Mangaung Metro as well as 16 district municipalities. In the Northern Cape and the Free State, 79% of the municipalities were in this category.

The following auditees were the main contributors (31%) to unauthorised expenditure in 2013-14 and also had significant increases from 2012-13:

- Tshwane Metro (GP) – R1 194 million (2012-13: R598 million)
- Nelson Mandela Bay Metro (EC) – R744 million (2012-13: R271 million)
- Matlosana (NW) – R655 million (2012-13: R477 million)
- Mangaung Metro (FS) – R498 million (2012-13: R20 million)
- Amajuba District (KZN) – R470 million (2012-13: R38 million)

Nature of the unauthorised expenditure

Overspending on the budget or main sections within the budget was the reason for 95% of the unauthorised expenditure. Continuous overspending on the budget was also one of the most common material non-compliance findings, as reported earlier in this section as well as in section 3.3, which reflect on the overspending on operating budgets in the context of financial health risks to local government.

Poorly prepared budgets, inadequate budget control and a lack of monitoring and oversight were some of the reasons for the overspending.

Municipal budgets also include budgeting for non-cash items, such as impairments and provisions, which is not actual expenditure but an accounting requirement that enables municipalities to assess the true value of their assets (such as equipment or debtors). In total, R6 962 million (61%) of the overspending that had caused the unauthorised expenditure was not actual payments in excess of the budget, but rather these accounting estimations that had been budgeted incorrectly. In total, 86% of the unauthorised expenditure by the main contributors listed above related to non-cash items. A total of 44 auditees (23%) incurred unauthorised expenditure only as a result of such non-cash items, to the value of R2 671 million.

Poor budgeting for non-cash items was the main reason for increases in those provinces with the highest increases in unauthorised expenditure. An estimated 28% of the increases in those provinces were as a result of increases in debt impairments of R650 million. Some auditees corrected these accounting estimates in the year in

response to their previous year audit opinions being qualified as a result of these incorrect estimates.

Excluding the portion of non-cash unauthorised expenditure, the following municipalities had the highest actual overspending:

- King Sabata Dalindyebo (EC) – R354 million (2012-13: R103 million)
- Tshwane (GP) – R270 million (2012-13: R46 million)
- Maluti-A-Phofung (FS) – R251 million (2012-13: R137 million)
- Madibeng (NW) – R175 million (2012-13: R0)
- Matjhabeng (FS) – R170 million (2012-13: R245 million)

Prevention, detection and disclosure

As detailed in the previous section on compliance, inadequate steps taken by municipal managers to prevent unauthorised expenditure were one of the most common material non-compliance findings. We reported the non-compliance as material at 142 municipalities (75%), based on them having incurred the same type of unauthorised expenditure in the current and previous years and our assessment that adequate controls and processes would have prevented it.

Figure 1 shows that we had identified 35% of the unauthorised expenditure amount during the audit process, which means that some auditees did not have adequate processes to detect and quantify the unauthorised expenditure. This is a regression from the 29% in the previous year.

Most auditees did not find it difficult to disclose complete and accurate information on unauthorised expenditure, as budget overspending was calculated and disclosed as part of the auditee's budget statements in the annual report. The disclosure of unauthorised expenditure in the financial statements was materially misstated at only 15 municipalities (6%), and we could not obtain sufficient and appropriate audit evidence for the amounts disclosed at 17 (6%).

Lack of consequences for unauthorised expenditure

At 100 municipalities (37%) (2012-13: 81 [30%]), the municipal manager and council did not investigate the unauthorised expenditure of previous years to determine if any person was liable for the expenditure.

Annexure 1 to this report gives further details of unauthorised expenditure.

3.2.4 Recommendations – compliance

Auditees with material findings on compliance with legislation, high levels of unauthorised expenditure and SCM weaknesses leading to irregular expenditure should strengthen their processes and controls to create and sustain a control environment that prevents, or detects and follows up, non-compliance with legislation. We recommend the implementation of at least the following key controls and best practices in place at some auditees:

- Auditee management should implement processes to identify all legislation that applies to financial and performance management in local government, and monitor changes to such legislation.
- Proper record keeping and specific measures to safeguard documentation, especially in the area of SCM, will enable compliance, but also demonstrate transparency and accountability on the part of auditees. It would further reduce concerns about possible fraud or irregularities where documentation cannot be produced for independent auditing.
- Compliance checklists should be implemented as a tool to supplement auditee policies and procedures. These will enable officials, supervisors and monitoring units (e.g. internal audit units) to independently check whether all legislative requirements are met in the daily transactional, management as well as SCM processes.
- Compliance monitoring should be introduced as a formal process at auditees, with clearly defined responsibilities assigned to senior officials whose performance in this regard must be assessed periodically.
- Regular reports to management and governance structures on compliance with key legislation, specifically in the area of SCM, will also promote awareness of legislative requirements and ensure that management deals with compliance in a regular and structured manner.
- Policies and procedures should be put into action fully to enable auditees to implement consequence management for officials who do not comply with applicable legislation, while appropriate and timely action must be taken against transgressors. A less tolerant approach should be taken by all parties, including those charged with governance and oversight, which will result in accountability being enforced and consequences being instituted against those who intentionally fail to comply with legislation. (Also refer to section 5.1 on HR management.)
- The council should ensure that the position of the head of the SCM unit is filled and that the official has the required minimum competencies. (Also refer to section 5.1 on HR management.)

Improved financial management that strengthens the processes of planning and budgeting, in-year monitoring and quality financial reporting will also lead to a decrease in unauthorised expenditure and material compliance findings on the quality of submitted financial statements, the preparation and control of budgets, and asset management.

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

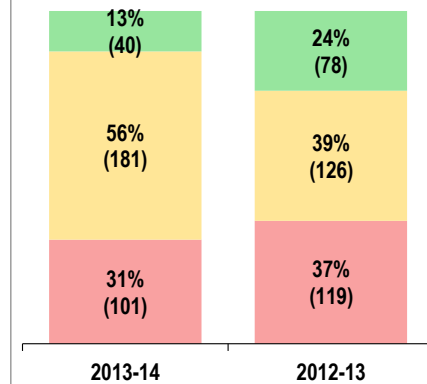


Figure 2: Financial health risks per auditee type

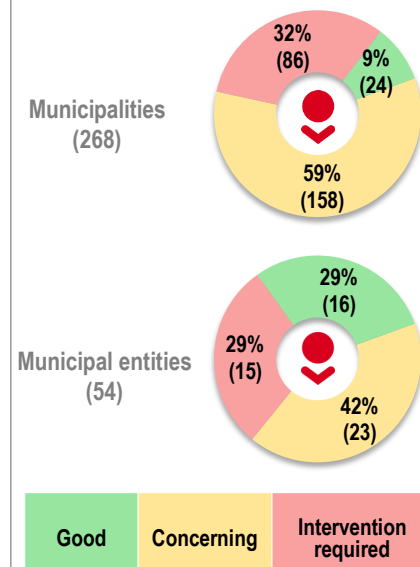


Table 1: Status of financial health

Province	Auditees with good status	Movement
Eastern Cape	10 (18%)	↑
Free State	1 (4%)	↓
Gauteng	5 (16%)	↓
KwaZulu-Natal	12 (17%)	↓
Limpopo	6 (19%)	↑
Mpumalanga	None	↓
Northern Cape	2 (7%)	↓
North West	None	↓
Western Cape	4 (13%)	↓

3.3 Financial health

Local government is at the centre of service delivery in South Africa. Beyond ensuring that they accurately reflect their financial position in the financial statements, comply with legislation and accurately report on their performance, municipalities and municipal entities should also ensure that they remain fiscally viable. A fiscally viable municipality is one in which municipal finances are used to the full benefit of residents and in which the continuation of service delivery is certain.

Against this background, our audits included a high-level analysis of 23 financial indicators to provide management with an overview of selected aspects of their current financial management and to enable timely remedial action where the auditees' operations and service delivery may be at risk. We also performed procedures to assess whether there were any events or conditions that might cast significant doubt on an auditee's ability to continue its operations in the near future. Three small municipal entities were excluded from the analysis.

Based on the analysis, each auditee was given an overall assessment as follows:

Good	Two or less unfavourable indicators
Concerning	More than two unfavourable indicators
Intervention required	Significant doubt that operations can continue in future and/or auditee received a disclaimed or adverse opinion, which meant that the financial statements were not reliable enough for analyses

Please note that the financial management analyses of financial statements that received disclaimed and adverse opinions are not reliable, as the problems in those financial statements are widespread and render them almost meaningless. In the same manner as we could not rely on this information, the analyses and financial health management of those auditees through the year are also called into question.

The auditees with an 'intervention required' status in figure 1 include all auditees with adverse and disclaimed opinions as well as those with material going concern uncertainties, as listed in annexure 4.

Figure 1 shows a significant regression in the number of auditees we assessed as having a good financial health status. As can be seen in figure 2, the regression is evident at both municipalities (from 49 to 24) and municipal entities (from 29 to 16). More municipal entities than municipalities were assessed as having a good status. The municipalities included seven district municipalities and 17 local municipalities.

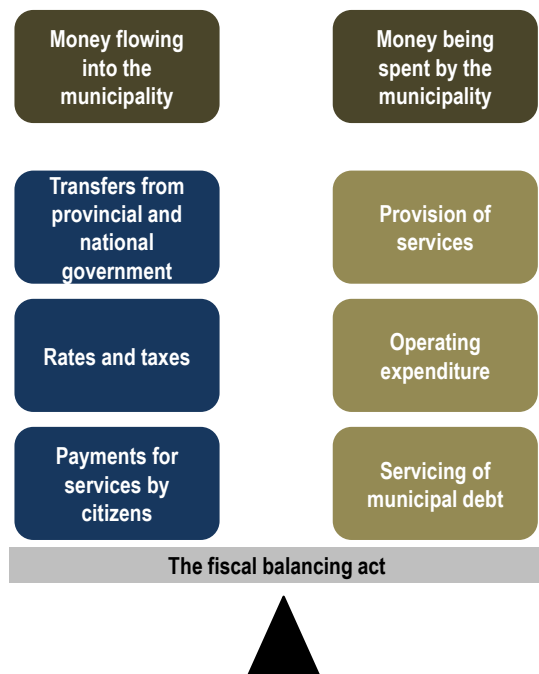
Table 1 indicates that there were regressions in all the provinces except the Eastern Cape and Limpopo. North West, the Free State and Mpumalanga had the fewest auditees with a good status, while KwaZulu-Natal and the Eastern Cape had the most.

Annexure 1 lists the overall assessment of each auditee and whether there has been an improvement or a regression in this area. The remainder of this section further discusses the findings from the analyses.

The National Treasury published a report in November 2014 entitled *The state of local government finances and financial management as at 30 June 2014*. The report assessed, among others, the financial health of municipalities based on the fourth quarter reports submitted to them by municipalities, and listed the municipalities they considered to be in financial distress. Our messages and those of the National Treasury are similar regarding the financial risks that local government faces as well as the municipalities that are most vulnerable and that should receive urgent attention from provincial and municipal leadership.

In order to deliver services to their residents and ensure the continuation of such services, municipalities need to carefully manage the money flowing in and the money being spent, as depicted in the following graphic:

Figure 3: Cash-flow management – the balancing act



As part of our assessment, we evaluated four aspects that relate to this balancing act:

- Whether the **financial position** of auditees was sound.
- Whether revenue collection was adequate to ensure a steady stream of income to finance service delivery activities (**revenue management**).
- Whether creditors were managed effectively (**meeting financial obligations**).
- Whether the **spending patterns** of auditees were sound.

Auditees in a poor financial position

A total of 70 auditees (22%) (2012-13: 76 [24%]) either disclosed in their financial statements that a material uncertainty existed with regard to their ability to operate in the foreseeable future (in other words, as a going concern) or received a qualified opinion because such disclosures were not included. The names of these auditees are included in annexure 4.

Please note that the following legend applies to figures 4 to 8 below:



Figure 4: Going concern uncertainty

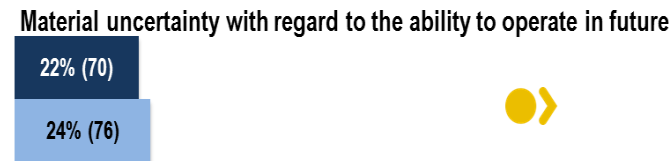
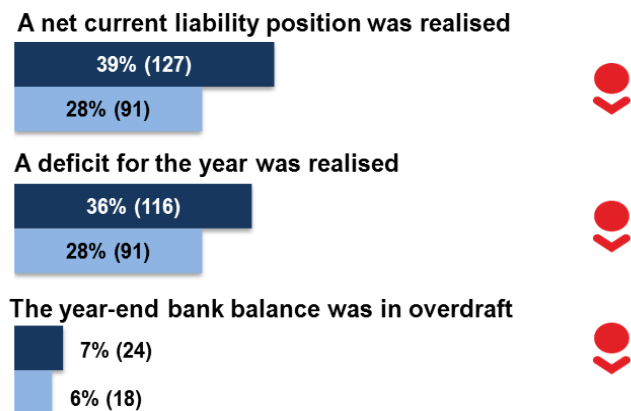


Figure 5 shows some of the typical indicators of going concern uncertainty in addition to the revenue management and creditor-payment period indicators detailed later on in this section.

Figure 5: Sustainability indicators



In total, 36% of the auditees spent more than the resources they had (and therefore a net deficit occurred), while for almost 40% the value of their current assets was less than that of their current liabilities at year-end (net current liability position). The year-end bank balance was in overdraft at 24 auditees. There was a significant increase in the number of auditees displaying these concerning indicators. The auditees included those listed in annexure 4.

The poor financial position of auditees was caused by non-payment or late payment by debtors, poor planning and budgeting, and inadequate budget controls and cash-flow management.

Even though most auditees would be able to continue their operations, the negative indicators raise concerns about the financial viability of some auditees (especially the municipal entities) and the pressure placed on acquiring additional funding from government.

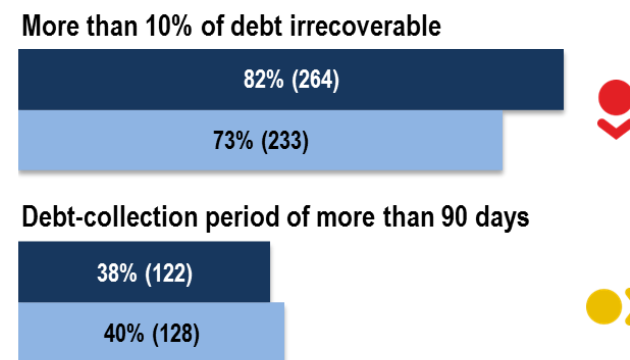
Revenue management

A key measure of fiscal viability is the availability of funding. In accordance with South Africa's legislative framework, most municipal funding should be derived from revenue collected from residents for services rendered. The collection of this revenue is made possible by various laws that provide municipalities with the authority to charge for services rendered, to collect money due, and to levy interest on outstanding amounts. This income allows municipalities to sustain their operations and to respond effectively to the needs of their residents.

Despite its importance, revenue collection at municipalities in South Africa remains weak. According to the National Treasury's report, the debt owed to municipalities at the end of 2013-14 was R94 billion.

Debtors are persons or entities that owe money to auditees, which in local government are mostly the rate payers and the receivers of municipal services, such as water and electricity. Debtors exclude those residents identified as indigents; in other words, residents that are too poor to pay for basic services. The figure below shows the results of our analyses of revenue management.

Figure 6: Revenue management



Just over 80% of the auditees estimated in their financial statements that more than 10% of the outstanding debt owed to them would not be paid, which is a significant increase from the previous year.

As part of our analyses, we calculated the average number of days it took for auditees to collect the money they determined to be recoverable. Almost 40% of the auditees had an average debt-collection period of over 90 days. The number of auditees with this financial risk indicator improved slightly in the year under review. The extended collection periods put the cash flow of the auditees under significant pressure, which in turn meant that they took longer to pay their creditors (also refer to the discussion below on extended creditor-payment periods).

Municipalities depend on the revenue from rates and municipal services to provide services to the communities and to fund infrastructure and other projects to achieve development objectives. We believe that debts are not recovered or take a long time to be recovered due to the following:

- Resistance among communities to pay for services.
- The poor economic climate and the increasing cost of services play a role. Some residents can no longer afford to pay for the services.
- As reported in section 3.2, many auditees have ineffective controls and processes to determine who owes money to them, to bill it correctly, and to collect the money. Inadequate management accounting and information systems that account for the revenue and debtors do not only affect the debt

collection but also the ability to account correctly for the debtors in the financial statements, as reported in section 3.1.

- There is a reluctance to hand over long-outstanding debts for collection. According to the National Treasury’s report, mayors and municipal councils do not provide the political backing for revenue enhancement and collection programmes.

The provision of water and electricity is a source of revenue for most municipalities. We raised concerns with the management of some auditees about the high percentage of **water and electricity losses**. These losses meant that municipalities purchased water and electricity but could not ‘sell’ all of it. In total, 101 municipalities and two municipal entities incurred electricity losses of more than 10%, while 66 municipalities and one municipal entity incurred water losses of more than 30%.

Meeting financial obligations

Another measure of financial viability is the extent to which municipalities are able to honour their commitments to suppliers who have provided goods and services (Eskom serves as an example). The goods and services provided by creditors to municipalities enable these municipalities to serve their residents. Timely payments to creditors ensure that these suppliers continue to supply municipalities, who in turn can then continue to provide services.

Creditors are persons or entities that auditees owe money to for goods and services procured from them. The MFMA states that auditees should pay their creditors within 30 days of receiving the relevant invoice or statement, unless prescribed or agreed otherwise. Figure 7 below shows the results of our assessment of creditor-payment periods.

Figure 7: Creditor-payment period

Creditor-payment period of more than 90 days



A total of 40% of the auditees took more than 90 days to pay their creditors, with little improvement since the previous year. As reported in section 3.2, the inability of auditees to pay within 30 days is one of the most common material non-compliance findings we had reported.

Delayed payments to creditors also indicate that some auditees were in financial difficulty and did not have the cash to honour their obligations. The late payment of

creditors can be linked to the recovery of debt discussed above: if debtors do not pay or do not pay in time, auditees have less cash and cannot pay their creditors in time. In total, 54 (17%) of the auditees had both poor revenue management indicators and delayed payments to creditors. These auditees included Mangaung Metro and Ekurhuleni Metro. Poor creditor management was also the result of poor cash-flow and project management.

Spending patterns

Municipal spending, which is mainly made up of capital and operational spending, should be aligned to service delivery priorities.

A **capital budget** is part of the approved annual budget set aside for developing and improving infrastructure, such as roads as well as water and sanitation systems, or to purchase assets, such as ambulances and refuse removal trucks. As many municipalities cannot raise enough revenue through rates and taxes to fund infrastructure projects and improvement programmes, national government contributes through **conditional grants**. There are conditions attached to using the money from the grants to ensure that they are used for their intended purpose and achieve the defined outputs. Section 3.4 analyses the management of the MIG, the MSIG and the FMG. For purposes of this section, we report on the use of all conditional grants. The figure below shows the results from our assessment relating to the spending of capital and operating budgets as well as conditional grants.

Figure 8: Spending matters

Underspending of the capital budget by more than 10%



Underspending of conditional grants by more than 10%



Overspending of the operating budget by more than 10%



Over half of the auditees underspent their capital budgets and 44% underspent their grants by more than 10%. The number of auditees that underspent has increased since the previous year.

The following are some of the reasons why auditees underspent capital budgets and conditional grants:

- A shortage of suitably skilled engineers and technicians to implement capital projects, especially at remote rural municipalities.
- Delays in appointing service providers as a result of poor planning and ineffective procurement processes.
- Inadequate reporting on key projects, the information reported not being credible, and a lack of action to address delayed projects.
- Cash-flow problems resulted in service providers not being paid, which in turn delayed projects.

Furthermore, a quarter of auditees overspent their operating budget by more than 10%. The overspending on budgets is also evident in the high number of auditees with unauthorised expenditure and the many auditees that had material non-compliance findings on overspending, as reported in section 3.2. Please note that this indicator is specific to the operating budget and only shows auditees that overspent by more than 10%, while the unauthorised expenditure by 190 municipalities, as described in section 3.2.3, includes all overspending and money not spent in accordance with the conditions of a grant.

The reasons for the overspending include the difficulties auditees face when they have to compile credible operational budgets and their inability to manage their operational expenditure in accordance with their budgets.

In total, 82 (26%) of the auditees had all three of these indicators, pointing to poor spending and budget management overall. These auditees included Buffalo City Metro, Mangaung Metro and City of Johannesburg Metro.

Conclusion

The National Treasury's report, *The state of local government finances and financial management as at 30 June 2014*, indicates that the World Bank's report for 2014 highlights municipal financial management challenges globally that are similar to those experienced in South Africa. It reports that municipalities are under increasing pressure to provide basic services while financial resources are dwindling.

In South Africa, the pressure on local government to perform is greater than ever with the focus on basic services as per the MTSF and persistent service delivery protests and pressure from communities. National and provincial government are channelling massive funding towards capacity building through grants, but results remain unsatisfactory.

Even though the ability of local government to report on their finances and performance is improving as demonstrated by the improved audit outcomes,

municipal managers and councils are not paying sufficient attention to the challenge of remaining financially viable. Doing more with less can materialise if, amongst other cost-saving initiatives, a concerted effort is made to curtail the extent and costs of using external providers. The SCM process should be used effectively to procure goods and services from the best providers at the best price – and only if the need cannot be addressed internally or through other means (e.g. through the support provided by national and provincial government). The great negotiation powers of local government as a collective, supported by national and provincial government, should also be considered and explored to bring down the costs of goods and services provided by the private sector.

3.4 Management of grants

Municipalities receive two types of allocations from the national revenue fund, namely equitable share and conditional allocations. Equitable share allocations are non-conditional, based on the municipality's share of revenue raised nationally. Conditional allocations are allocated for a specific purpose, and include:

- allocations to municipalities to supplement the funding of functions funded from municipal budgets
- specific-purpose allocations to municipalities
- allocations-in-kind to municipalities for designated special programmes
- funds not allocated to specific municipalities that may be released to municipalities to fund immediate disaster response.

Conditional allocations are approved each year through DoRA. DoRA will indicate the approved allocation per type of allocation per institution for that particular year, together with a forward estimate of allocations for the next two years.

With regard to forward estimates, the following take place before a set deadline for the final allocation to be approved through DoRA:

- Each municipality must agree on the provisional allocations and the projects to be funded from those allocations. This information is sent to the national transferring officer.
- After consolidating the information for each municipality, the transferring national officer submits the final allocation list and the draft grant framework for each allocation to the National Treasury for approval.

Municipalities may only use a conditional allocation for its intended purpose in accordance with the requirements of each grant framework 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.

This section provides the results of these tests for the MSIG, the FMG and the MIG.

Grants to improve financial and performance management

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

The **MSIG**'s strategic goal is to have local government as an efficient and developmental sphere of government capable of delivering services to local communities. The grant is aimed at building the capacity of municipalities to implement sound institutional and governance systems required in terms of the MSA.

The core outcome of the grant is to have a responsive, accountable, effective and efficient local government system. In order to achieve the core outcome, annual targets must be set in respect of the following expected outputs derived from the MSIG framework:

- Number of municipalities with information systems that support effective service delivery.
- Number of municipalities with strengthened administrative systems enabling effective implementation of the ward participation system.
- Number of municipalities developing by-laws, policies and systems that support local government legislation.

For this purpose, municipalities must submit a signed activity plan in the prescribed format with detailed budgets and time frames for the implementation of prioritised measurable outputs.

The **FMG**'s strategic goal is the secure, sound and sustainable management of the fiscal and financial affairs of municipalities. The grant aims to promote and support reforms in financial management by building capacity in municipalities to implement the MFMA.

The following are the intended outcomes of the grant:

- Improved capacity in the financial management of municipalities.
- Improved and sustained skills development, including the appointment of at least five interns per municipality supporting the implementation of financial management reforms focusing on the gaps identified in MFMA support plans.
- Appropriately skilled financial officers appointed in municipalities consistent with competency regulations.
- Improvement in budget practices consistent with budget reforms.

- Improvement in the management of revenue and expenditure, assets and liabilities.
- Improvement in SCM practices.
- Timely submission of financial statements and improved audit outcomes.
- Improvement in municipal governance and oversight.

In order to achieve these outcomes, annual targets must be set in respect of the following expected outputs derived from the FMG framework:

- Number of municipal officials registered for financial management training.
- Number of interns appointed per municipality.
- Submission of MFMA support plans.
- Preparation and implementation of multi-year budgets.
- Improved submission of financial management reports.
- Improvement in SCM practices.
- Number of internal audit units and audit committees established.
- Preparation and implementation of financial recovery plans, where appropriate.

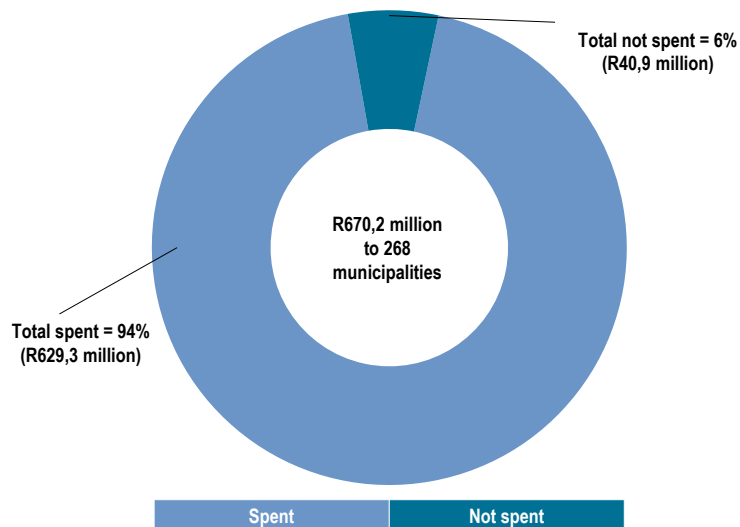
For this purpose, municipalities must submit MFMA implementation and support plans, which include measures or programmes to address weaknesses in financial management. In allocating the funds, priority is given to municipalities with a low revenue base and weaker capacity to enable them to sustain the financial management reforms. The allocation should be spent in accordance with the submitted MFMA implementation and support plan.

Municipal systems improvement grant and financial management grant

For the 2013-14 financial year, a total of R665,1 million was allocated through DoRA for the MSIG (R240,3 million) and the FMG (R426,4 million).

Due to unspent funds rolled over from the previous financial year, the 268 municipalities being reported on had R670,2 million to spend on programmes funded from the MSIG and the FMG. The following figure shows the spending of the allocation:

Figure 1: Spending of municipal systems improvement grant and financial management grant



Of the available R670,2 million, R629,3 million was spent – translating into a spending of 94%. However, 61 municipalities underspent by more than 10%. Most of these municipalities were from the Eastern Cape and KwaZulu-Natal, with 11 municipalities each. Interestingly, R147,3 million was spent on consultants, indicating the extent to which municipalities are using consultants to support financial management and service delivery reforms funded by the MSIG and the FMG (also refer to section 5.2 on the use of consultants).

Figure 2: Achievement of targets – municipal systems improvement grant

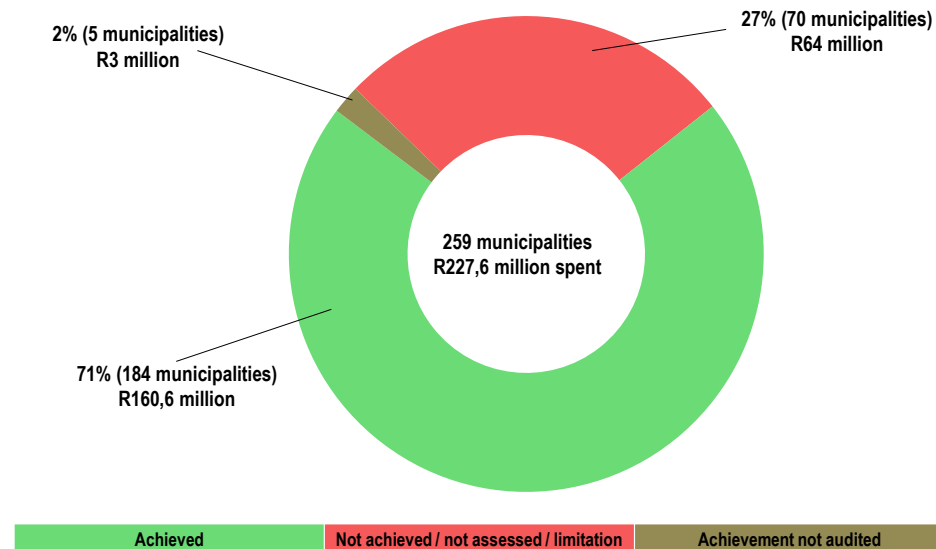
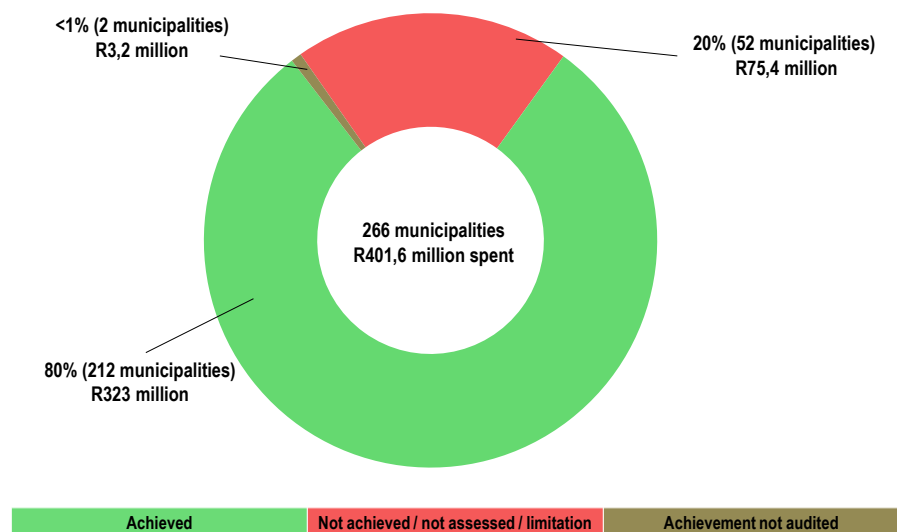
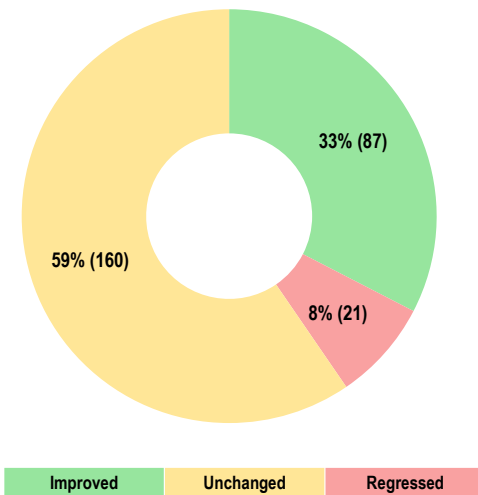


Figure 3: Achievement of targets – financial management grant



Although 94% of the available funds were spent, only 184 municipalities (71%) achieved their MSIG targets and 212 municipalities (80%) achieved their FMG targets. Even though the municipalities used the money allocated to them, many were still struggling to achieve their targets.

Figure 4: Movement of audit outcomes of municipalities funded by the municipal systems improvement grant and/or the financial management grant



Although conditional grant allocations of R629,3 million were spent on improving financial and performance management, it did not have a positive 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; for example, the appointment of interns who only received training for 12 months and then left.
- A lack of ownership by management, resulting in slow progress to address commitments and key control weaknesses aimed at improving financial management.
- A number of municipalities in this category utilised consultants for their financial reporting. Due to the late appointment of consultants and/or weaknesses in managing the consultants, such consultants could not improve the audit outcomes.
- Some municipalities in this category 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.

This further illustrates the lack of correlation between spending and achieving the intended impact. Although 87 (33%) of the municipalities that had received allocations improved their audit outcomes, the bulk of 160 (59%) remained stagnant and 21 (8%) regressed. This means that only a third of the municipalities took advantage of the allocations to improve their audit outcomes. Efforts must be increased to ensure that there is correlation between the spending of grants, the achievement of targets, and the desired impact at the rest of the municipalities.

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 poor households, micro-enterprises and social institutions servicing poor communities.

In achieving the core outcome, annual targets must be set in respect of the following expected outputs derived from the MIG framework:

- Number of additional poor households receiving basic water and sanitation services.
- Number of additional poor households serviced by sport and recreation facilities.
- Number of additional kilometres of municipal roads developed.
- Number of additional poor households serviced by solid waste disposal sites and transfer stations.
- Number of additional poor households serviced by street or community lighting.
- Number of work opportunities created using the guidelines of the expanded public works programme for the above outputs.

For this purpose, municipalities must annually submit business plans to CoGTA. The grant uses the registration requirements of the MIG management information system to register, track and monitor projects as per the business plans. Such plans should include timelines regarding project designs, initiation of procurement, environmental impact assessments and relevant permit or licence approvals in the prescribed format.

For the 2013-14 financial year, R14,3 billion was allocated through DoRA for the MIG. Due to unspent funds rolled over from the previous financial year, the 238 municipalities being reported on had R15,5 billion to spend on infrastructure projects funded from the MIG. Figure 5 depicts the spending of the allocation.

Figure 5: Spending of municipal infrastructure grant

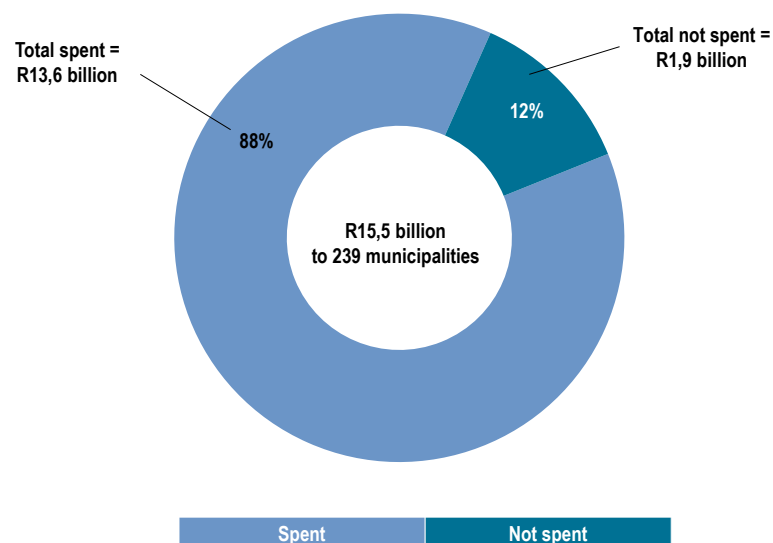
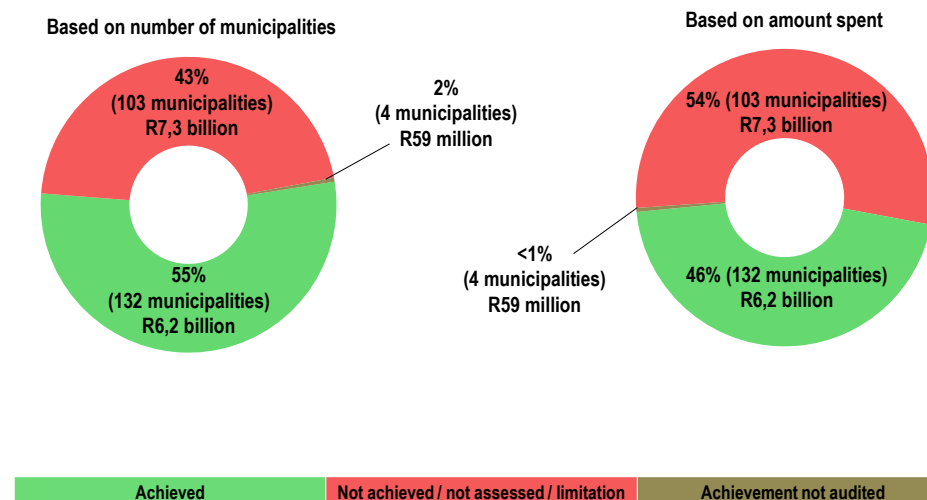


Figure 6: Targets achieved



Of the available R15,5 billion, R13,6 billion was spent – which translates into a spending of 88%. However, 91 municipalities underspent by more than 10%, most notably in the following provinces:

- KwaZulu-Natal – 22
- Limpopo – 17
- Eastern Cape – 15
- Northern Cape – 13
- North West – 11

Figure 6 depicts the achievement of MIG targets based on the number of municipalities and the amount spent.

We tested the reported performance against planned targets in respect of the MIG at 235 municipalities. Although most of the allocations had been spent (88%), this does not correlate with the achievement of targets. A total of 43% of the municipalities that received MIG allocations did not achieve the planned targets. Municipalities that did not achieve the targets spent the bigger part of the allocation (54%). The following provinces had the highest number of municipalities in this category:

- Eastern Cape – 28
- KwaZulu-Natal – 18
- Northern Cape – 14
- Limpopo – 14
- North West – 11

Management provided the following as the most common reasons for the underperformance of the grant:

- Lack of adequate capacity due to vacancies and suspensions in key positions.
- Lack of proper planning, resulting in the late appointment of implementing agents.

- Inadequate project management, resulting in poor performance on the part of contractors.
- Using allocations for purposes other than those stipulated in DoRA or the gazetted framework.

Non-compliance with the Division of Revenue Act

As reported in section 3.2, our compliance audits also focused on the transfer of funds and conditional grants (but not just the grants discussed above). In total, 69 (26%) of the 268 municipalities that received conditional grants via a DoRA allocation did not comply with the act, mainly due to the following:

- Allocations were utilised for purposes other than those stipulated in DoRA or the gazetted framework – 27 municipalities. These municipalities were in all the provinces except Gauteng, with the majority (10) being in the Eastern Cape.
- The performance of the programmes funded by allocations was not evaluated – 51 municipalities. These municipalities were in all the provinces except Gauteng, with the majority in North West (12), the Eastern Cape (11), the Northern Cape (nine) and the Free State (eight).
- The unspent portion of the conditional grant was retained at year-end without the approval of the National Treasury – 13 municipalities. Most of these municipalities were in the Northern Cape (four), while the remainder were in the Free State, Limpopo, the Eastern Cape, the Northern Cape and North West.

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