**4. Report of the Standing Committee on the Auditor-General on the Integrated Annual Report of the Auditor General of South Africa for the Financial Year 2016/17, dated 24 November 2017**

The Standing Committee on the Auditor-General (SCoAG), having considered the 2016/17 Integrated Annual Report of the Auditor-General of South Africa on 17 November 2017, reports as follow:

**1. Introduction**

1.1 The Auditor-General of South Africa (AGSA) is established in terms of Chapter 9 of the Constitution, and is a state institute supporting constitutional democracy. The Constitution guarantees the AGSA’s independence, and requires that the office operates in an impartial manner, and performs its functions without fear, favour or prejudice.

1.2 Section 10(3) of the Public Audit Act, No 25 of 2004 (the Act) requires that the National Assembly provides for a mechanism to maintain oversight of the Auditor-General in terms of section 55(2)(b)(ii) of the Constitution. Accordingly, the Rules of the National Assembly provide for the establishment of the Standing Committee on the Auditor General (the Committee). The Committee is charged with assisting and protecting the AGSA in order for the latter to maintain its independence, impartiality, dignity and effectiveness.

1.3 According to section 10(1) and (2) requires the AGSA to annually submit the following documents to the National Assembly:

 - a report on the activities and performance;

 - a report on overall control of administration; and

- the AGSA’s annual report, financial statements and the audit report on those statements.

Accordingly, the AGSA tabled its 2016/17 Annual Report on 15 September 2017.

1.4 This report has been divided into the following four parts:

- Part A, dealing with performance information;

- Part B, dealing with financial information;

- Part C, dealing with the appointment of an external auditor; and

- Part D, containing SCoAG’s observations and recommendations.

**Part A**

**2. Performance Information**

**2.1 Environment/Background**

2.1.1 In 2016/17 the AGSA’s strategy was in part informed by the following conditions in their environment which had the potential to affect delivery on their mandate:

* sustained low economic growth, which resulted in fiscal constraints on the delivery of government programmes;
* the AGSA demonstrated its commitment to transformation through its signing of the revised *Chartered Accountancy Profession Sector Codes* and the distribution of contract audit work and other organisational practices to develop and advance black chartered accountants;
* increased public concern about poor governance and consequence management in the public sector resulting in calls to strengthen the AGSA;
* unpaid fees pose a threat to the AGSA’s sustainability, and the AGSA managed to stay viable in 2016/17 through the collection of fees through litigation against auditees who failed to pay them for their services, and through the ring-fencing;
* the scarcity of skilled professionals remains a challenge and demanded continuous development and talent retention efforts;
* the ever-evolving and increasingly complex auditing environment requires the AGSA to ensure that its skills and tools remained current too; and
* resistance from auditees who through, for example, delaying the submission of information, excluding auditors from important meetings and intimidating auditors, posed a challenge but also confirmed that the AGSA’s relevance and effectiveness.

**2.2 Reporting format**

2.2.1 The AGSA’s reporting format is based on Global Reporting Initiative, the sustainable reporting guidelines and the international integrated reporting framework.

**3 Overview of non-financial performance**

The AGSA’s performance is structured around four strategic goals that support the institution’s vision for the public services.

3.1 *Value-Added Auditing*

3.1.1 Value-added auditing is aimed at providing audit-derived valuable insights to stakeholders regarding the status of their internal control and performance environment, accompanied by actionable recommendations which, if implemented, should result in visible improvement in public sector administration.

3.1.2 In this regard, the AGSA reported that:

- 91 per cent of the 959 audits that were conducted were concluded within the legislated timeframes;

- 143 interim annual performance plan reviews were conducted;

- 2 general reports on the status of financial and performance management was produced;

- 3 standalone performance audit reports on the urban renewal programme, water infrastructure provision, and the management of pharmaceuticals, were tabled;

- the 2015/16 **Public** Health sector report on the use and maintenance of medical equipment, planning and maintenance of infrastructure, management of medical waste, and management of anti-retroviral medication was published; and

- the 2015/16 Education sector report on the procurement processes for text books was published.

3.1.3 The AGSA reports that it had improved its approach to section 4(3) audits. Where the AGSA opted not to conduct audits, only 57 per cent of the section 4(3) entities complied with the requirements of the Act in respect of the appointment of registered auditors. To address this shortcoming, the AGSA:

 - published a revised audit directive to guide the audit process for section 4(3) entities;

 - instituted a structured process to engage with non-complaint entities;

- improved processes for monitoring the appointment and discharge of external auditors; and

- participated in key meetings with entities and auditors.

3.1.4 The AGSA increased the technical quality of its audits and succeeded to develop an improved audit methodology which was piloted at selected auditees in the 2015/16 audits. It will be fully implemented from the 2017/18 audit cycle.

3.1.5 During the Public Finance Management Act, No 1 of 1999 (PFMA) and Municipal Finance Management Act, No 56 of 2003 (MFMA) audits, the AGSA adopted an integrated audit approach which is being institutionalised slowly. The legal support to its audit teams was increased, which resulted in the improvement of legal advice and a reduction in the turnaround time for attending to legal queries. At the time of reporting a legal curriculum was being rolled out to auditors.

3.1.6 The AGSA also expanded its knowledge of auditees’ business using available information and data-analytics which, allowed for better sampling and risk identification.

3.1.7 In order to ensure that more stakeholders were reached, the AGSA enhanced its packaging of reports and messages. The AGSA therefore

- improved the General Reports process to ensure that insight was made available faster; and

- provided individual ministers, directors-general and heads of department with extracts of the 2015/16 PFMA General Reports.

3.1.8 The AGSA strived to reduce the cost of auditing, but the following factors impacted negatively on this effort: auditees lack of attention to improve the control environment; increased risks at auditees; and resistance to audit opinions.

3.2*Visibility for Impact*

3.2.1 This objective structures the AGSA’s engagement programmes to encourage and enable the required improvements in the public sector, i.e. to encourage stakeholders to implement its recommendations.

3.2.2 The AGSA held over 3 500 meetings with various stakeholders, and conducted 159 of 181 planned engagements with prioritised stakeholders.

3.2.3 The status of records and commitments review programme was developed and piloted, and will in the short term be the AGSA’s primary tool for engagement with auditees.

3.2.4 In the period under review, the AGSA engaged several professional organisations and individuals, including the South African Local Government Association (SALGA), the King IV report launch, and Institute of Internal Auditors South Africa (IIASA) conferences. These interactions were aimed in the main at seeking views with regard to how the Act may be strengthened. The AGSA reports widespread support for the strengthening of the Act to ensure the implementation of its mandate.

3.2.5 In addition to the above, the AGSA also engaged the general public through, amongst others, discussions on community radio stations; public lectures; social media; and the AGSA’s magazine, *Audit Thought Leader*.

3.2.6 The AGSA has chaired the International Organisation of Supreme Audit Institutions (INTOSAI) Capacity Building Committee (CBC) since 2013. Since then the CBC has succeeded in adopting its first framework to professionalise regional organisations, adopted a global competency framework for public sector audit professionals; and endorsed the International Standards of Supreme Audit Institutions (ISSAI) 5600 and 5800 on cooperative audits and peer reviews as two key approaches to building capacity.

3.2.7 In respect of Organisation of English-speaking African Supreme Audit Institutions (AFROSAI-E), the AGSA shared its expertise with its counterpart in Sudan, supported capacity-building initiatives for young women leaders through the AFROSAI Women Leadership Academy programme; and hosted delegations from China and other African countries in order to share knowledge and experience.

3.3*Developing Human Capital* **(***Legal and Administrative**Viability)*

3.3.1 This objective focusses on the AGSA’s internal workings, and is aimed at ensuring that the organisation had the necessary resources, i.e. an enabling legal framework; independent financial resources; and the required skills, competencies and culture to execute its mandate economically, efficiently and effectively.

3.3.3 With regards to its personnel, the AGSA managed to maintain a 91 percent occupancy level, experienced an 8.1 per cent staff turnover, and exceeded the national average of women’s representation by 10 per cent (i.e. 55 per cent of its employees are women).

3.3.4 The AGSA plans to limit its headcount and has therefore recruited fewer new employees. Further, the AGSA has focused on internal appointments to fill leadership posts. Its leaders have strengthened their capacity and improved performance, i.e. 164 executives and senior n managers were trained in building relationships; and 118 participated in coaching, mentoring and executive development programmes. Consequently, the total expenditure of the AGSA’s investment in learning and development increased from R77,6 million in 2015/16 to R90,8 million in 20016/17.

3.3.5 Information Communication Technology (ICT) tools and infrastructure were improved in the period under review. The AGSA succeeded to upgrade its enterprise resource planning (ERP) to streamline and automate processes; updated its audit software to ensure business continuity.

3.4*Vision and values*

3.4.1 The AGSA aims to, through its work and behaviour, continually demonstrate that clean administration and transformation are achievable. The AGSA maintained its clean audit in 2016/17.

3.4.2 In respect of risk and ethics management, the AGSA:

- improved its risk maturity level from ‘risk managed’ to ‘risk defined’.

- revised its ethics policy so as to ensure that its employees had a guiding framework on ethical conduct and decision-making;

- provided clear guidelines on political neutrality;

- introduced a 12-month cooling-off period for high risk officials such as senior managers, before they could take up employment with auditees;

- finalised 12 of the 15 ethics complaints it received; and

- observed an increase in category three complaints which could be attributed to greater awareness of its complaints resolution process.

3.4.3 The AGSA received Level 2 B-BBEE recognition for the third consecutive year, and anticipated that the re-introduction of the CA Charter will assist them to maximise their contribution to the transformation of the profession.

3.4.4 Two small audit firms benefited from the AGSA’s enterprise development programme with one of them graduating to become part of the AGSA’s supply chain.

3.4.5 In respect of contract work, AGSA outsourced audits to 104 black-owned firms across all provinces, the vast majority of them small, were used for audit work. They were awarded 1 050 contracts to the value of R584 million (i.e. 20 per cent of its revenue), covering pre-issuance reviews, regularity audits, information system audits, and performance audit services.

**Part B**

**4. Financial Information**

**4.1 Income and expenditure highlights**

4.1.1 For the 2016/17 financial year, the AGSA recorded revenue of R2 977 million. This represents an approximately 5 percent increase compared to the previous financial year. This increase was below the average inflation rate of 6.3 percent for the period under review.

4.1.2 On the other hand, the AGSA has spent an amount of R3 053 002 on its operations. The main cost drivers were direct cost of auditing, and overhead costs, which include investment in information technology, support and capacity building.

4.1.3 At the end of the period under review, the AGSA’s deficit stood at approximately R14,58 million, representing a significant set-back – in 2015/16 the AGSA reported a surplus of R105 million. Importantly, the reported total deficit was a culmination of implementing strategic/catch up projects (R26,6 million) and unbilled hours (R83 million). Thus, had it not been for these afore-said cost drivers, the AGSA would have achieved a surplus of R95 million.

4.2 *Debtors balance/outstanding debts*

4.2.1 At the end of the 2016/17 financial year, outstanding debts amounted to R806 million, which represents a 19 per cent increase from the previous financial year’s balance of R679 million. Local government debt remains the main contributor to the current total debts- municipalities owe about 41 percent of audit fees. Provinces such as the Eastern Cape, Free State, Northern Cape and North West are the main contributors to the local government debt. They jointly accounted for about 80 percent (R309 million) of outstanding local government debt.

4.2.2 In addition, section 23(6) of the Act requires that if the local government audit fees exceed one per cent of the total current and capital budget, such excess should be defrayed from National Treasury’s Vote. The AGSA reported that the number of financially distressed municipalities grew from 71 in 2014 to 86 in 2016. For the 2016/17 financial year, National Treasury paid R79 million, and R42 million for the previous year. Thus, the outstanding balance of R321 million for financially distressed municipalities and 1 percent debtors remains a significant strain on cash flows.

4.2.3 Provincial departments’ debt increased from R128 million in 2015/16 to R150 million at the end of 2016/17. This amount includes aging debt not paid within 30 days of invoicing, while national departments owe R90 million. This amount also includes aging debt not paid within 30 days of invoicing

**4.3 Financial health**

4.3.1 At the end of the period under review the AGSA’s financial position showed total assets amounting to R1,6 billion, and total liability amounting to R573,2 million. The liabilities include retirement benefit obligations, operating lease liability and trade and other payables.

4.3.2 Despite its debt collecting challenges, the balance sheet points to a healthy financial position.

**Part C**

5*. Appointment of External Audit Executive*

5.1.1 The Committee, on behalf of Parliament, appoints the AGSA’s external auditor on behalf of Parliament, for a three-year period. The appointment is reviewed annually.

5.1.2 The AGSA’s Audit Committee facilitates the external auditor’s appointment through a process fair, equitable, transparent, cost effective and in line with the AGSA’s transformation agenda.

5.1.3The Audit Committee has reported that despite having undertaken three tender processes, it has not been able to identify a firm to be appointed as an external auditor. At the time of reporting the Audit Committee was awaiting the outcome of a fourth tender process. The Audit Committee informed the Committee of its intention to relax certain of the criteria should this tender not yield any results.

**Part D**

**6.1 Observations**

*Deficit recorded for the year*

6.1.1 The Committee observed that the deficit recorded by AGSA was temporary and only for the period under review. For the next two financial years, AGSA projects that it will generate surplus of 2.1 per cent and 1.3 per cent, respectively. As alluded to above, the deficit generated in the period under review was due to once off payments, which will not be carried over to the next financial years. These include, unbilled hours and special catch-up projects. In relation to the unbilled hours, the AGSA proposes to increase audit fees by 3 per cent in order for the service to remain affordable, and to implement a revised audit methodology aimed at reducing audit hours or time spent auditing the accounts of low risk auditees. The special/ catchupprojects involve the purchasing of 800 notebooks and the roll-out of audit methodology training.

6.1.2 Despite the above, the AGSA indicated that they would, in the next financial year, apply their cost cutting measures, which include the reduction of overhead costs, in particular those related to the filling of the vacant positions. It is important to note that these measures will not affect the organisation’s, as an impact assessment will be done before the decision not to fill a vacancy is taken.

*Non-payment of Audit fees*

6.1.3 It is clear that the challenge of outstanding audit fees is two-pronged. There are outstanding audit fees owed by the auditees which are financially capable to pay their audit fees on the one hand. On the other hand, there are audit fees owed by financially distressed auditees (mostly municipalities), whose audit fees should, in line with section 23(6) of the Act be defrayed in the National Treasury’s budget vote.

6.1.4 The AGSA has since the 2015/16 financial year implemented debt collection methods that are in line with the Act, to collect outstanding fees from auditees other than those that are in financial distress. These methods include ring-fencing agreements and litigation strategies. The AGSA enters into ring-fence agreements that allow auditees to clear their backlog of debt, or issues letters of demand and summons to auditees. These debt collection methods have been effective as is evident in the AGSA’s report that it collected a total of R354 million in the period under review i.e. 56 per cent more than the R197 million collected in the previous financial year.

6.1.5 In addition, the Committee observed that the outstanding balance for the financially distressed auditees was R321 million at the end of 2016/17 financial year. With regard to this issue, National Treasury has proposed an amendment to section 23(6), which will ensure that AGSA and National Treasury agree on the criteria municipalities had to meet to be categorized as ‘financially distressed’. In that way, the monies to be paid by National Treasury is known in advance.

6.1.6 The Committee however notes that at present it was not clear whether the failure to pay audit fees was deliberate or resulted from mismanagement of funds which ultimately resulted in the budget for audit fees, which is ring-fenced, being depleted too.

*Contestation of audit findings*

6.1.7 The Committee notes with concern the increase in auditees’ challenging the AGSA’s findings. The Committee views these challenges as undeserved, disruptive and costly.

6.1.8 In addition to legal challenges from auditees, the AGSA has also been accused of having “ulterior motives”, its auditors have been threatened, and attempts made to influence the outcome of the audits through bribery. The Committee was informed that most of such allegations are levelled after the AGSA issues its findings. We are pleased that the AGSA investigates all such allegations internally, and that in most cases it has absolved its auditors of wrong-doing.

*Outsourcing*

6.1.9 The Committee notes the AGSA’s explanation that owing to the periodic nature of its work, it made better financial sense to outsource a number of its audits. This position is informed by the cost-benefit analysis the AGSA conducted in 2006 to establish the most affordable option for performing its audits.

6.1.10 The Committee welcomes the AGSA’s decision to reduce KPMG’s two-year contracts, to a one-year contract ending March 2018, pending the outcome of the Independent Regulatory Board for Auditors (IRBA) and South African Institute of Chartered Accountants (SAICA) investigations into allegations of misconduct against the firm.

*Auditing of state-owned enterprises*

6.1.11 In light of the serious governance and financial management challenges among state-owned enterprises (SOEs), the Committee is pleased to note that the AGSA has started preparations to extend the scope of the audits it performed itself to include more SOEs. These preparations include the review of its audit methodology to include other expertise such as lawyers, engineers, etc., and allowing some of the AGSA’s employees to attend the quarterly audit committees’ meetings of certain SOEs.

*Awareness-raising campaigns*

6.1.12 The Committee notes the increased public awareness of the AGSA’s significance and importance as a constitutional body. Further, the Committee notes that through its awareness raising campaigns the public is better informed of the impact mismanagement of public funds on service delivery.

 *External Auditors*

6.1.13 The Committee notes the challenges experienced as far as identifying an external auditor, as well as the efforts underway to address the impasse.

**6.2 Recommendations**

 The Committee’s recommendations are contained in paragraphs 6.2.1 to6.2.6below.

6.2.1. The AGSA should continue to implement its debt collection methods—ring-fencing and litigation strategies—until an appropriate and sustainable solution is found **to** ensure that audit fees are paid. National Treasury should be engaged on this matter too. The Committee will exercise its legislative powers to support AGSA to implement debt collection initiatives.

6.2.2 National Treasury and provincial treasuries should assess the credibility of municipalities’ proposed annual budgets to ensure that those budgets provide for operating costs, in particular the costs emanating from statutes e.g. audit fees. National and provincial treasuries should during their annual process of assessment of proposed municipal budgets ensure that adequate provision is made for audit fees.

6.2.3 Consideration should be given to the feasibility of only signing off on audits once an auditee has settled its audit fees*.* The AGSA should on a quarterly basis report to the Committee on:

- progress made as far as collecting debt is concerned; and

- all unresolved challenges to its audits, their overall impact, and efforts to resolve them.

6.2.4 The AGSA should give due consideration to increasing its capacity so as to include more state-owned enterprises among the audits it performs itself. The Committee should be provided with a business proposal in this regard by 31 March 2018.

6.2.5 The AGSA’s public awareness-raising efforts should be intensified to expand the public’s understanding of auditing terminology.

6.2.6 The Committee notes the challenges experienced as far as identifying an external auditor. While it is not opposed to the requirements for experience in public sector auditing and five partners being relaxed, it is strongly opposed to the broad-based black economic empowerment, gender representivity and the requirement that the firm’s fee should represent 15 per cent or less of its annual income being relaxed. The Committee should be provided with the details of the firm that has been identified by 14 December 2017.

***Report to be considered***