Workshop: Interpretation of AFS Oversight
19 MARCH 2018
Introduction and Overview
• Purpose of the workshop
• Municipal Accountability Cycle

Legislative Overview and Accounting Policies
• Key Legislative Requirement
• Accounting Policies

Oversight Committees
• Municipal Council
• Council Committee
• Advisory Committee

Process on AFS
• Municipal Accountability Cycle
• Introduction to the process of AFS
• Preparation of the AFS
• Demonstration of the complete set of AFS

Audit Process
• Auditor General’s role
• Forms of Audit Opinion
• Emerging Risk
INTRODUCTION AND OVERVIEW

• MEC FOR FINANCE Requested SALGA to conduct workshop for councillors on Interpretation of the Annual Financial Statements

• The presentation aims to provide an overview on the relevant legislation, oversight committees, audit process and enlighten councillors on the oversight responsibilities upon annual financial statements

• The purpose is for councillors to be able to understand at basic level the Annual Financial Statements and the required political leadership role to ensure improved audit outcomes that translates that sustainable service delivery

• The expected participation is that we own the session and guide it to achieve the desired outcome
MUNICIPAL POLITICAL AND ADMINISTRATIVE ACCOUNTABILITY
RELEVANT LEGISLATION AND ACCOUNTING POLICIES
Municipal Finance Management Act [MFMA] Reforms

- Generally Recognised Accounting and Reporting Standards – uniform financial reporting in an accrual basis;
- Municipal Regulations and Guidelines on Minimum Competency Levels – Gazette 29967, 15 June 2007; - to assist and guide municipalities to implement MFMA sections 83, 107, 117 and 119 on competency levels by appointing appropriately competent municipal official charged with financial management responsibilities against key positions;
- Municipal Asset Transfer Regulations – Gazette No. 31346, 22 August 2008; - to assist municipalities to manage and account for asset transfers, disposal, usage process in line with the issued reforms while ensuring that assets that are immediately needed for service delivery purposes and are not disposed of unduly;
- Municipal Budgeting and Reporting Regulations – Gazette No. 32141, 17 April 2009; - to assist municipalities to budget in line with the issued MFMA chapter 4, among others, ensure that the budget is funded and maintain uniformity in the budgeting process of municipalities and facilitate ease of interpretation across municipalities on similar areas of the budgeting process;
MFMA Reforms…continued

• Municipal Regulations on Standard of Chart of Accounts – Gazette No. 37577, 22 April 2014; - to assist municipalities with uniform norms and standards in classifications and to improve quality and consistency in reporting in a transparent and accountable manner and to facilitate comparisons across the sector;

• Municipal Regulations on Financial Misconduct and Criminal Proceedings – Gazette No. 37699, 30 May 2014; - to assist municipalities to implement MFMA chapter 15, identify, process and manage allegations of financial misconduct and to facilitate a process to institute criminal proceedings for any financial management misconduct.
ACCOUNTING POLICIES

• Internal Reserves
• Impairment of Financial Assets
• Property Plant and Equipment
• Employee Benefits
• Provision for doubtful debts
• Unforeseen and Avoidable Expenditure
• Unauthorised expenditure
• Fruitless and Wasteful expenditure
• Irregular Expenditure
• Financial and Operating lease
• Changes in accounting policies, estimated and errors
• Commitments
• Budget Information
• Events after reporting date
What does the public expect from the municipality?

- A fair, equitable, reliable and sustained delivery of basic services such as water, sanitation, electricity, refuse removal, etc.

- Regular and effective consultation with all stakeholders on service delivery-related matters;

- Transparency and accountability in all matters of budgeting, financial management, supply chain management, service delivery, etc.
OVERSIGHT COMMITTEES
EXECUTIVE COMMITTEE
“Sound Financial Management & Accounting”

• Applicable to municipalities with over 9 councillors

• Responsible for:
  – passing by-laws
  – Approving municipal budget
  – imposing rates and taxes
  – approving IDP

• Council Committee:
  – S79 portfolio committees
  – S80 portfolio committees
Establishment of oversight committees
The municipal is operationally not complex but overregulated and vulnerable to corruption

Terms of Reference:
- Oversight on Annual Report
- Investigate the Unauthorised Expenditure
- Monitor Fruitless and Wasteful expenditure
- Investigate Irregular Expenditure
- Review monthly budget report
- Review organisational performance report
Establishment of Internal Audit
Roles and Responsibilities:

- Performance Agreement for Section 57
- Annual Financial Statements
- Annual Budget Preparation Plan
- Auditors General Report
- Mid-Year Report
- Annual and Oversight Report
- IDP and SDBIP
- AG Implementation Plan
Establishment of the Audit Committee

Role and Responsibility:

- Advise council, Accounting officer and Management:
  - Internal financial controls and internal audit
  - Risk management and accounting policies
  - Adequacy, reliability and accuracy of financial reporting
  - Performance management and effective governance
  - Compliance with the relevant legislations (MFMA)
  - Application of a coordinated combined assurance model to all assurance activities
PROCESS ON ANNUAL FINANCIAL STATEMENTS
WHY PREPARE AFS?

AFS form an integral part in the Municipal Accountability Cycle

MUNICIPAL ACCOUNTABILITY CYCLE
WHY PREPARE AFS?

The Constitution of South Africa gives rise to public accountability, as the public has a right to know how tax monies collected by and on behalf of the Fiscus is utilised.

Auditors i.e. Auditor General’s Office use the municipality and municipal entity’s annual financial statements to conduct and audit and express an Opinion thereon, PROVIDED, the AFS are Prepared in accordance with the MFMA, NT, and GRAP frameworks, Legislation and reporting requirements

Other users of AFS include but are not limited to, private companies who May want to assess financial viability of AFS prior to entering into business And contractual arrangement and contracts
INTRODUCTION TO THE PROCESS OF AFS

The MFMA requires municipalities and municipal entities to compile and submit AFS for auditing by 31 August (or 30 September in the case of consolidated financial statements) of each year.

The submitted AFS for auditing must be free from material misstatements. Misstatements refer to incorrect or omitted information in the financial statements i.e. incorrect or incomplete classifications of transactions.

The Auditor General audit the financial statements to express an audit opinion on whether the financial statements fairly present the financial position of the municipality/auditee at financial year-end and the results of their operations for that financial year.

The reputation of a municipality with clean audit does not necessarily translate to service delivery however yield opportunities for infrastructure funding.
PREPARATION PROCESS OF THE AFS

1. Analysis of Business Transactions
2. Make Journal Entries
3. Post to Ledger Accounts
4. Prepare Trial Balance
5. Make Adjusting Entries
6. Adjusted Trial Balance
7. Prepare Financial Statements
8. Close Accounts
9. Post-closing Trial Balance

Accounting Cycle
IDENTIFYING ANNUAL FINANCIAL STATEMENTS (AFS)

The COMPLETE SET OF AFS detailed in the previous slide are presented in the following ORDER:

- General Information
- Accounting Officer’s Responsibility and Approval
- Statement of financial position (GRAP )
- Statement of financial performance
- Statement of changes in net assets
- Cash flow statement (GRAP 2 )
- Statement of comparison of budget and actual amounts
- Accounting policies (GRAP 3)
- Notes to the Annual Financial Statement

• Note: Appropriation statement to be included (NT requirement)
AFS: GENERAL INFORMATION

GENERAL INFORMATION

- Name (and previous if changed) of Municipality and Municipal Entity
- Year end and period covered
- Presentation currency (Rand in the case of SA Municipalities and Municipal Entities)
- Level of rounding
- Domicile and legal form
- Country of incorporation
- Address of registered office
- Description of operations
- Details of CFO and Executive Leadership
AFS: DETAIL-CONTENT

STATEMENT OF FINANCIAL POSITION:
- Current vs Non-current – operating cycle
- Minimum on the face (par 79 GRAP 1)
- Either on the face or in the notes (par 86 GRAP 1)

STATEMENT OF FINANCIAL PERFORMANCE:
- All items of revenue and expenditure
- Minimum on the face (par 96 GRAP 1)
- Either on the face or in the notes (par 102 GRAP 1 –material)
- Expenditure either nature / function

STATEMENT OF CHANGES IN NET ASSETS:
- On the face

CASH FLOW STATEMENT
- ALL CASH inflow and outflow transactions (even though AFS are prepared on accrual basis)
- On the face
NOTES TO THE ANNUAL FINANCIAL STATEMENTS

Notes follow a systematic basis presented as follows:

- Statement of compliance with Standards of GRAP
- Summary of significant accounting policies applied
- Supporting information for items presented on:
  - the face of the Statement of financial position;
  - The face of the Statement of financial performance;
  - The Statement of changes in net assets,
  - Cash Flow Statement
- Statement or statement of comparison of budget and actual amounts in the order in which each line item and each financial statement is presented; and
- Other disclosures, including: Contingent liabilities and unrecognised contractual commitments and Non-financial disclosures, e.g. entity’s financial risk management objectives and policies; UFI expenditure
AFS: OVERALL CONSIDERATIONS

Fair presentation & GRAP compliance – must be 100% compliant with GRAP

- Prepared on a Going concern assumption (Financial position of municipality must NOT cast significant doubt on ability of municipality to continue its service delivery, creditor and debtor obligations)

- AFS prepared must be:
  - Accrual basis – except for cash flow
  - Materiality – all material amounts must be disclosed (NB! for Auditing purposes)
  - Offsetting – asset, liabilities, revenue and expenditure shall
  - No offsetting unless required / permitted
  - Display Comparative information – reclassification – disclosure! i.e. Prior Year figures, transactions and reporting

UNDERSTANDABLE   RELIABLE   COMPARABLE   CONSISTENT   RELEVANT
AFS: RATIO ANALYSIS

Profitability Ratios
- Gross Profit Margin
- NOPAT %
- Profitability %

Liquidity Ratios
- Current Ratio
- Quick Ratio
- Operating Cash Ratio

Efficiency Ratios
- Return On Equity
- Return On Total Assets
- ECROCE

Working Capital Ratios
- Account Receivable Days
- Account Payable Days
- Inventory Days

Asset Usage Ratios
- Asset Turnover Rate
- Activity Ratio
- Working Capital Absorption

The Financial Ratios
**Working Capital Ratios:**

**Inventory turnover (Inventory/Cost of Sales x 365)-**

\[
\frac{5152}{59474.80} \times 365 = 32 \text{ days}
\]

**Collection Period (Accounts Receivable/Sales/Revenue Collected x 365)-**

\[
\frac{3326.2}{72445.10} \times 365 = 17 \text{ days}
\]

**Settlement Period (Accounts Payable/Cost of Sales x 365)-**

\[
\frac{10500.60}{59474.80} \times 365 = 64 \text{ days}
\]

**Working Capital /Operating Cycle Days (Inventory +Collection – Settlement)**

\[
32 + 17 - 64 = -15 \text{ days}
\]
Liquidity ratios:

Current ratio = (Current assets / Current liabilities)

R 9467.10 / R 11 355 = 0.834

Acid test ratio (Current assets - Inventory / Current liabilities)

9467.10 - 5152 / 11 355 = 0.380
### Efficiency Ratios

<table>
<thead>
<tr>
<th>Efficiency Ratios</th>
<th>Formula</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Equity</td>
<td>Efficiency x Profitability x Leverage</td>
<td>(^{(\text{Profit}/\text{Equity})\times 100})</td>
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<tr>
<td></td>
<td>Revenue x Profit x Total Assets</td>
<td>Total Assets x Revenue x Equity</td>
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<tr>
<td></td>
<td>73 477.30 x (1 065.40)</td>
<td>16 984.90</td>
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<tr>
<td></td>
<td>16 584.90 x 73 477.30 x 100</td>
<td>3 897.80</td>
</tr>
<tr>
<td></td>
<td>4.43 x 1.45% x 4.36</td>
<td>28%</td>
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ROLE OF AUDITOR GENERAL (AG)

The AG checks the spending of Public Money by looking at whether it has been used ideally and for the purposes intended.

This exercise is performed two months after each financial year end.

The AG Annual Audits examine 3 areas:

- Fair presentation and absence of significant misstatements in financial statements
- Reliable and credible performance information for predetermined objectives
- Compliance with all laws and regulations governing financial matters
FORMS OF AUDIT OPINION

- **CLEAN AUDIT OUTCOME**
  - The financial statements are free from material misstatements and there are no material findings on reporting on performance objectives or non-compliance with legislation.

- **FINANCIALLY UNQUALIFIED AUDIT OPINION WITH FINDINGS**
  - The financial statements contain no material misstatements with findings on either reporting on predetermined objectives or non-compliance or both these aspects.

- **QUALIFIED AUDIT OPINION**
  - The financial statements contain material misstatement in specific amounts or there are sufficient evidence to conclude that the specific amounts included on the AFS are not materially misstated.

- **ADVERSE AUDIT OPINION**
  - The AFS contain the material misstatements that are not confined on to specific amounts or the misstatements represents a substantial portion of the financial statements.

- **DISCLAIMER AUDIT OPINION**
  - The auditee provided insufficient evidence in the form of documentation on which to base an audit opinion.
AUDITING OF NON-FINANCIAL INFORMATION

AUDITING OF REPORTING ON PREDETERMINED OBJECTIVE
- Municipalities are required to report on annual performance against the predetermined objectives
- The purpose is to determine if the reported information is useful and reliable in all material aspects based on the predetermined criteria
- The reported performance must be valid, accurate and complete

AUDIT OF COMPLIANCE WITH LEGISLATION
- Measure compliance of the municipalities in terms of financial management, performance management, transparency, accountability, stewardship and good governance
Recurring audit issues

- Non-compliance with the MFMA and in particular SCM regulations – lack of understanding of SCM prescripts, vacancies, instability and a lack of SCM processes and procedures, incorrect application of SCM regulations 36, Functioning of SCM committees (BEC, BAC, etc), Poor contract management, Deviations from competitive bidding processes

- Prevention and identification of Unauthorised, irregular and fruitless and wasteful expenditure. Irregular expenditure decreased from R344 million in 2014-15 to R210 million in 2015-16. The irregular expenditure does not necessarily represent wastage or mean that fraud has been committed – this needs to be confirmed through investigations to be done by the council – but losses could already have arisen or may still arise if follow-up investigations are not undertaken. The track record of local government in dealing with irregular expenditure and ensuring that there is accountability is poor.

- The significant amounts can be attributed overall to a weakening in SCM at municipalities, particularly in the areas of competitive bidding (46%) and obtaining three quotations (56%), which led to irregular expenditure.
AUDIT OPINION DRIVERS

Financial Statements
- Infrastructure and equipment
- Irregular expenditure
- Revenue

Compliance with SCM and other regulations
- Quality of financial statements submitted
- Prevention of Unauthorised, Irregular, Fruitless and Wasteful Expenditure
- Management of Procurement and or contracts
- Strategic planning and performance management
- Consequence Management

Performance Information
- Reporting on indicators that are not well defined
- Reported information not consistent with objectives and or targets
- Reliability of annual performance reports
WC Audit outcomes over 3 years

- 2016-17:
  - Unqualified with no findings: 70% (22)
  - Unqualified with findings: 9% (5)
  - Qualified with findings: 9% (5)
  - Adverse with findings: 3% (1)
  - Disclaimed with findings: 3% (1)

- 2015-16:
  - Unqualified with no findings: 75% (24)
  - Unqualified with findings: 19% (6)
  - Qualified with findings: 3% (1)
  - Adverse with findings: 3% (1)
  - Disclaimed with findings: 3% (1)

- 2014-15:
  - Unqualified with no findings: 72% (23)
  - Unqualified with findings: 25% (8)
  - Qualified with findings: 3% (1)
  - Adverse with findings: 3% (1)
  - Disclaimed with findings: 3% (1)
EMERGING AUDIT RISKS

- Standards of GRAP
- mSCOA
- Guideline on accounting for arrangements undertaken in terms of the national housing programme
- Minimum requirements for composition of bid adjudication committees (BAC)
- Use of national contracts procured by other organs of state
- Suppliers in service of state
- Deviation from competitive bidding processes
- Exemptions as result of severe drought
- Performance management system for employees other than section 56 and 57 employees
- Minimum competency framework
THANK YOU
ENKOSI
BAIE DANKIE