

**Presentation by the AG to the Labour Portfolio Committee  
(17 October 2006)**

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**Programme**

1. Role of the Auditor-General
2. Audit process and types of audit reports
3. Audit opinions – what do they mean?
4. Root causes to audit issues raised
5. Department of Labour
6. Unemployment Insurance Fund
7. National Skills Fund

## **1. Introduction**

Distinguished members of the Labour Portfolio Committee, thank you for this opportunity to address you today.

Having just about come to the end of my term of office and looking back over the past seven years in office and the many interactions I have had with the Committees of the National Assembly, I must state upfront that I have great respect for your work.

As you are aware, strong oversight by Parliament is an essential element of an effective democracy. It is my function as an Auditor-General to examine and report on the accountability information brought to parliament annually so that you can hold government and its senior officials to account in an informed manner. As an institution established to "support constitutional democracy" in terms of chapter 9 of our South African Constitution, I appreciate the opportunity to share with you as the members of the Labour Portfolio Committee some thoughts on oversight and the interaction with yourselves, before I also provide you with a brief overview of the audit outcomes of the 2005-06 audits of the national department of Labour and its public entities.

With that as background, I then wish to address you today on:

- The role and mandate of the AG
- The types of audits we do and the audit products we send to Parliament
- The different types of audit opinions we issue, and
- Issues and root causes related to opinions expressed on entities in the Labour portfolio

## **2. Role and mandate of the AG**

The South African audit legislation has evolved substantially since 1911 and in 1996 the Constitutional Assembly provided the Auditor-General with constitutional status, something not yet achieved in most so-called “first-world” democracies. And then in 2004, the National Assembly passed the *Public Audit Act*, thereby providing a comprehensive and progressive statutory framework within which we as a modern and professional Supreme Audit Institution can operate to the benefit of all stakeholders.

## **3. Types of audits and audit reports**

### **Regularity audits**

Regularity auditing is also known as a financial statement audit and is an independent examination of the information disclosed in the financial statements of departments and public entities as well as compliance with key financial legislation.

The Public Finance Management Act requires that every regularity audit report must be included in the annual report of the department and must be audited within two months of receipt of financial statements from the department.

The audit process has the following key phases:

- Planning
- Field work
- Reporting

**What does a regularity audit provide?**

- Indicates the reasonableness and reliability of the financial statements
- The validity of the disclosure of inputs into the organisation, e.g. assets procured and personnel costs
- Identifies areas of poor controls and potential fraud, as well as areas of non-compliance with key financial legislation
- Reports on the adequacy of the control environment, specifically the internal audit function
- Reports on the matters identified during the course of the audit that are in the public interest.

**I think that it would be particularly relevant for me to advise this Committee on what a regularity audit does not provide?**

- Effectiveness of financial management
- Outputs and service delivery
- Efficiency and effectiveness of controls or actual fraud
- Total picture of malpractices

- Comprehensive information on areas of improvement
- Adequacy of the overall governance structure

### **Performance information audits**

I am sure that the Committee is quite interested in these types of audits. The issuing of an opinion or conclusion on “the reported information relating to the performance of an auditee against predetermined objectives” became a requirement as per the Public Audit Act of 2004.

I have decided on a phasing-in approach towards the auditing of performance information. This phasing-in approach provides for ongoing advice on, and encouragement of, continuous improvement in the quality, value and use of performance information until such time as it is reasonable to expect that all the suitable and predetermined criteria have been established, communicated and can be met by the departments and entities. As the quality of reported performance information improves, users will view the performance information provided as of equal or greater value than the financial information that they already expect and receive audit assurance on. Together with the National Treasury and the DPSA, we are working towards expressing an audit opinion or conclusion on performance information, which is the ultimate goal. Until then, the phasing-in audit approach will be followed. Therefore, at this time, let me reiterate that I do not express a view or opinion on programmes or service delivery.

### **Performance audits and special investigations**

This type of audit is also sometimes called a *value-for-money audit*, or an audit of *efficiency, effectiveness and economy*. Performance audits focus on a specific department or a specific area within a department. We also carry out special transversal audits, which are those performance audits conducted simultaneously at national and provincial departments. Special investigations are conducted in response to a request by the executive authority, the relevant management or a legislative body.

A performance audit is an independent review to evaluate the measures instituted by management to ensure that allocated resources are being procured economically and utilised efficiently and effectively and to report thereon.

The performance audits undertaken within the Labour Portfolio, specifically the vote, for the 05/06 financial year were performed on Inspectorate and a follow up audit was conducted on Indlela.

### **Auditing standards**

You may ask what standards ensure that you receive reports of a professional quality? We audit mainly in terms of the South African Auditing Standards, which is harmonised with the International Standards of Auditing. We use internal quality assurance processes to continuously monitor adherence to applicable standards. Annually, compliance with these standards is reviewed by the Independent Regulatory Board of Auditors, previously the Public Accountants' and Auditors' Board.

#### 4. Audit opinions

The auditor will express an opinion based on the evidence obtained during the execution of the audit. The opinion would be based on how material the error or omission is. Information is material if its omission or misstatement could influence the economic decisions of the users taken on the bases of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances.

Since audit opinions are often technical or complex to understand, I will try to elaborate on this aspect more specifically by explaining the different types of audit opinions.

**Unqualified Audit Opinion:** An unqualified opinion or “clean opinion” is expressed when the auditor concludes that the financial statements give a true and fair view in accordance to the applicable financial reporting framework.

**Emphasis of matter:** Where the auditor wishes to highlight a matter which is already dealt with in the financial statements, without changing our audit opinion, but which is very important to users e.g. non-compliance to laws and regulations and going concern problems.

**Qualified Audit Opinion:** A qualified opinion is expressed when the auditor concludes that the error or omission will not result in a true and fair view of the financial statements.

**Disclaimer of opinion:** This is the term given to reports where the auditor simply does not know whether fair presentation has been achieved or not. For example, a significant portion of the auditee's records being unavailable and making it impossible for the auditor to gather sufficient appropriate evidence, and hence to form an opinion.

**Adverse opinion:** This is the term given to reports where the auditor is of the opinion that the true and fair view of the financial statements has not been achieved due to disagreement with management.

## 5. Root Causes

It is important to understand the underlying problems leading to audit observations so as to implement proper corrective measures rather than only addressing symptoms. A root cause is the main underlying reason for the occurrence of the reportable item (error or omission).

The salient root causes resulting in the modification of the audit opinions expressed on the annual financial statements of the 5 entities forming part of the Labour portfolio can be categorized into the following areas which are all mainly related to inadequate financial management:

- (i) Capacity or people related issues (high vacancy levels and lack of financial skills)
- (ii) System related matters (inadequate financial reporting systems, inadequate business processes and inadequate non-financial reporting systems); and

- (iii) Governance arrangements (compliance issues and inadequate or lack of policies)

These root causes will become more evident as I take you through the various issues that resulted in the modification of the audit opinions of the Department of Labour and its four related entities.

## **6. Overview of Audit Opinions expressed and root causes**

A. I will commence with the National Department of Labour.

A qualified opinion was expressed based on the fact that a true and fair presentation of the value of assets in existence could not be validated in the financial statements.

The root cause/s for the qualification is due to the Logis system's inherent limitation in providing information to support the non-cash additions of R33m to fixed assets and the asset register of the PPP agreement with Siemens Business Services not indicating the value of the assets.

Further to the qualification, an emphasis of matter paragraph was included for the following matters:

- Travel and subsistence expenditure - The Department did not complete a reconciliation between the BAS and PERSAL systems on a monthly basis. A reconciliation was only performed once covering the whole year.

- Non-compliance to laws and regulations – Due to capacity constraints within management, monitoring compliance to laws and regulations could not be done effectively. As a result, irregular expenditure occurred in some cases.
- Performance information – The Department has not yet created a system whereby the performance information could be linked to the overall objectives of the strategic plan.
- Physical security over inventory – Due to capacity constraints within Supply Chain Management there was no proper policy and procedures for the counting of inventory at year-end resulting in some items not being counted.
- Policy Framework – The write-off of long outstanding debt, HR plan and Supply chain Management policies was all in draft format due to top management not taking responsibility to approve these policies.

## **Performance Audit**

### **Inspection and enforcement services – Reporting**

#### **Database – recording of accidents**

No national database with reliable statistics of accidents and incidents of ill-health of all role players exists due to the different reporting agencies having different criteria for determining what accidents and occupational diseases must

be reported upon and there is a lack of a responsible person to drive and monitor the process.

#### **Incidents on Occupational Safety System (IOSS)**

The IOSS was only functional at provincial office level as no timeframes were set for the implementation thereof at labour centres due to the development of the IOSS being terminated a number of years ago.

#### **Institute for the National Development of Learnerships, Employment Skills and Labour Assessments (Indlela).**

#### **Underutilisation of training centre**

The anticipated increase in candidates to be assessed and the optimal utilisation of facilities as a result of the decentralisation of the assessment function to the provinces and private firms had not been realised as a result of the apprentice system being replaced by the learnership system.

B. Let me now move on to the Unemployment Insurance Fund on which I expressed an unqualified opinion with an emphasis of matter for the following issues:

- Benefit payments to contributors – The controls around the benefit payments to contributors were found to be ineffective due to the following reasons: Firstly human errors occurred during capturing information on the system, secondly the information systems of the UIF, Department of Social Development and Compensation Fund are not capable of integrating with one another and thirdly, the reports

available from information systems are not user friendly to perform verification of information.

- Bank reconciliation process – Lack of management monitoring of the reconciliation process lead to the large volume of unreconciled debits of R12,9 million and credits of R5,1 million being unresolved.
- Accuracy of contribution revenue – Controls to administer the employment information were found to be ineffective as information supplied by employers to the fund could not be verified to a reliable source document.
- Benefits paid in error – Lack of management implementing an effective control framework to monitor collection of overpayments.
- Non-compliance to laws and regulations – Due to an oversight by management various laws and regulations were not complied with.
- Services rendered by the Department of Labour – The UIF has no system in place to ensure the accuracy and validity of expenses allocated by the Department of Labour to the Fund.
- Supply Chain Management – Due to limited understanding of the requirements of the Treasury Regulations, management did not implement a supply chain management system.

- Internal Audit - The internal audit section did not function effectively mainly due to a lack of monitoring of the internal audit plan by management.

C. Next is the Compensation Fund, which was qualified on the basis of the following:

- Completeness and accuracy of revenue contribution – Lack of capacity has resulted in the fund experiencing a backlog in the raising of assessments. No systems to verify the accuracy of information submitted by employers was in place.
- Valuation of assessment debtors – Oversight by management to monitor the accuracy of assessments raised and debtors raised is not sufficient.

Further to the qualification an emphasis of matter paragraph was included for the following matters:

- General Computer controls – Deficiencies in the general control of the fund exist. Management did not ensure that sufficient controls were implemented.
- Internal Control weaknesses – General controls within the Compensation Fund are weak due to lack of formal routine and approved policies and procedures, inadequate management information and inadequate supervision and review.

D. Now on to the National Skills Fund (NSF), which was also qualified on the basis that the accounting framework resulted in the financial statements not being fairly stated for the following reasons:

- Firstly the NSF utilizes the accounting system BAS which does not cater for the accrual system of accounting. The result of this was that the accruals were materially understated. The indecision on the legal structure of the NSF by top management attributes to the utilization of the incorrect accounting system.
- Secondly the lack of qualified skilled employees, responsible for the reporting and accounting of the transactions for the NSF, resulted in the incorrect passing of journal entries to the bank and accumulated fund accounts. The proper disclosure of the result of the journal entries for prior year errors was lacking.
- Thirdly, lack of skills resulted in the incorrect accounting of other income.

Further to the qualification an emphasis of matter paragraph was included for the following matters:

- The policy and framework regarding the structure and accountability has not been finalized due to the non-decision of top management and related committees.

- Policy Framework – The write-off of long outstanding debt policy was in draft format due to top management not taking responsibility to approve these policies.
- Mandab – The decision taken by the Director-General not to extend the duration of the Mandab Steering Committee members terms of office lead to funding not being allocated to projects. No one has taken the responsibility for the effective control of Mandab funding resulting in an ineffective control environment.

E. The last of the labour related entities is the Sheltered Employment Factories (SEF), which was qualified in the form of a disclaimer of opinion as the auditor simply does not know whether fair presentation has been achieved or not. Sufficient appropriate evidence could not be obtained for the following reportable items:

- Fixed assets
- Accounts receivable
- Impairment of debtors
- Accounts payable
- Related party transactions
- Operating leases
- Transport costs

The main underlying reasons for not obtaining sufficient appropriate evidence can be summarised as follows:

- Staff in key financial positions lacked formal qualifications and experience in accounting, finance and information systems.

- Internal audit reviews were not frequently performed at SEF
- Lack of a comprehensive policies and procedures manual that is specific to the operating activities of SEF
- Inadequate monitoring and independent reconciliations and reviews by senior management

SEF has departed from the prescribed accounting framework (GAAP) in various aspects, due to a lack of a definitive legal form.

Further to the disclaimer of opinion, an emphasis of matter paragraph was included for the following matters:

- Non-compliance with laws and regulations – The indecision on the legal structure by top management attributes to the non-compliance with laws and regulations.
- Internal control weaknesses - Inadequate technical accounting skills, information technology and marketing knowledge and internal control awareness at SEF lead various weaknesses in the control environment.
- Performance audit – The Department has not yet created a system whereby the performance information could be linked to the overall objectives of the strategic plan.

## 7. Conclusion

The frequency of interaction between the AG and the National Assembly Committees – other than SCOPA – has steadily increased, especially in the past year or two. I must admit that we are not always clear on the expectations of the portfolio committees. Being used to the work methodology of SCOPA, our briefings to SCOPA are aimed at a detailed analysis at year-end of the state of well-being of financial management within a department or entity in order to identify the critical areas that require corrective action. Portfolio committees (PCs) probably require input of a different kind from the AG.

Our understanding is that oversight by portfolio committees, amongst other things, includes the general effectiveness of departments and entities so that optimal service delivery can take place. The PCs seem to therefore not require a detailed understanding of the financial management position within a department or entity, but only a bird's-eye view. However, I anticipate that the PC would have to have a thorough understanding of the human resource capacity of a department or entity, including the financial management staff, or put differently, its financial management capability.

In addition, the PCs would probably have a keen interest in the governance arrangements within the department or entity. In our experience, it is only once an institution's governance processes run smoothly, that it will be in a position to deliver on its mandate. The challenge is not simply to ensure that all elements of corporate governance are effectively in place, but that its purposes are fully understood and integrated as a coherent and comprehensive organisational strategy focused on being accountable for its conduct and results.

Another possible area that PCs could be provided with a bird's-eye view by the AG, is the quality of the systems producing the financial and non-financial performance information. However, there may be some other areas that we are not aware of and that fall within the AG's mandate and area of knowledge or capability.

I therefore hope that my presentation today has assisted you in putting my role in context while at the same time, providing you with a high-level view of my audit reports on the labour portfolio entities. I trust that my observations have been of interest to you. If there is time, I will gladly take any questions that you may have.

Thank you very much.