The Audit Committee's role in financial analysis in Municipalities

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1. Purpose of this paper

The purpose of this paper is to provide guidance to Audit Committee members firstly, to critically assess whether the municipality has a suitable strategy within the Integrated development plan (IDP) and Service delivery budget implementation plan (SDBIP) in place and whether this strategy is being implemented to manage its financial resources effectively in order to meet its service delivery obligations and secondly on issues to consider when evaluating the planning, monitoring and reporting of the fi nancial information of municipalities. The audit committee's role is one of oversight. As part of this oversight mandate, audit committees should guide management where necessary. This means that audit committees need to have a robust understanding of the municipality's fi nancial strategy focus areas in the context of its IDP, SDBIP, Medium term expenditure framework (MTEF) and Annual budget and be able to analyse the actual fi nancial performance to ensure that the municipality has the financial resources to meet its service delivery mandate and obligations.

This document has two parts, the first relates to financial strategy focus areas and the second part relates to interpretive analysis of financial ratios. By considering both these elements, audit committee members will be able to provide value adding strategic input on the financial and operational performance of the municipality.

2. Background

Municipalities play a central role in the provision of basic services to the country's citizens and business as a whole. They are the conduit through which government delivers on most of its social and infrastructure development objectives. Section 153 of the Constitution of the Republic of South Africa requires that a municipality must structure and manage its administration, budgeting and planning processes to give priority to the basic needs of the community, and to promote the social and economic development of the community. The MFMA and Municipal Systems Act (MSA) aims to facilitate compliance with this constitutional duty by ensuring that municipalities' priorities, plans, budgets, implementation actions and reports are properly aligned.

In accordance with the Municipal Finance Management Act No.56 of 2003 (MFMA), Audit Committees of municipalities are tasked to advise and provide recommendations to the Municipal Manager, i.e., the Accounting Officer, Senior Management and Council relating to the adequacy, reliability and accuracy of the financial reporting and financial and non-financial information, in terms of planning, monitoring and reporting. This is to improve accountability and governance over the activities of municipalities and municipal entities.

The municipality's financial performance should be assessed regularly by means of the financial ratios which provide an insight into the level of achievement of actual service delivery outcomes for that year and enable the municipality to adjust its plans to the actual achievements and spend.

Audit committees must remain mindful of that fact that financial performance and a clean audit report will not mean much if actual service delivery has not taken place and if the constituents of the municipality do not have access to the basic services they require.

3. Challenges facing municipalities

Municipalities in South Africa are classified as Metropolitan, Local and District. It is important to understand the unique challenges facing the different types of municipalities as this will influence the type of analysis which the audit committees will need to take into consideration in performing their duties. Typically, these challenges include:

- Level of financial management skills, experience and knowledge;
- Sophistication of internal controls, processes and systems including Information Technology;
- Credit ratings;
- Governance structures leading to weaknesses in internal controls and non-transparent procurement processes and
- High turnover of senior management in municipalities, particularly the accounting officer and the chief financial officer. This is a major issue affecting municipalities' capacity to manage their finances properly and to lay a sound foundation to expand and improve service delivery
- Communities may not have access to basic services;
- Infrastructure is not maintained and additional funding is therefore needed for maintenance purposes;
- High levels of poverty resulting in some customers being unable to pay for services, resulting in lower revenue for the municipality. Furthermore, a higher level of indigent community members and limited access to funding and financing.

4. Access to appropriate complete and accurate information

The duties and responsibilities of Audit committees are comprehensively explained in the MFMA legislation which govern municipalities. In addition to the legislative requirements, the King Code and Report on Governance for South Africa (King IV) provides further guidance on the roles and responsibilities of audit committee members. It is not the purpose of this paper to elaborate on those requirements, however it is important to note that the audit committee members require access to management and other information flows in order to discharge their duties effectively.

The content of data made available to audit committees should be timely, accurate and complete. It is important that audit committees are aware of the key issues facing the municipality and have access to the appropriate financial and performance data and other reports in order for them to perform analysis which will enable them to ask the right questions. This is critical in order for audit committees to discharge their duties and provide strategic input on the financial and operational performance of the municipality.

5. Financial strategy focus areas and best practice examples

Audit committees should consider the following focus areas in providing strategic input on the financial and operational performance of the municipality. Ultimately audit committee members should be able to strategically advise municipality management to ensure that sufficient funds are available to meet the needs of the community and the mandate of the municipality in terms of the IDP and SDBIP.

Strategic Focus Areas	Guidance For Audit Committee
Strategic focus for municipal management	Consider whether management has considered the impact of changes in the macro and micro economic environment which will affect the municipality in the longer term e.g. local government and municipal elections, CPI (consumer price index measuring inflation), interest rates and Eskom tariffs and provide insight to management.
Budgeting process In terms of the MSA, the budget must be mutually consistent with the IDP and SDBIP and include projections for at least the next three years. The budget must be based on realistic revenues given past collections to ensure that the municipality is financially sustainable, i.e. the municipality is able to successfully manage its financial resources to support service delivery to its citizens while settling obligations as they fall due.	**Establish that budgeted revenue collection is aligned to revenue collected in the prior years and whether:** • Price increases of the regulator (for example NERSA’s price increases for electricity) have been taken into consideration. • Inflation factors have been considered. • Non collection from indigent debtors and other factors affecting collection of revenue. • The rates roll has been updated per the legislation to maximise rate collections. • All possible revenue streams have been explored. **The audit committee should confirm that management took the following into account:** • The estimated expenditure is realistic when compared to known factors such as national Treasury’s cost containment considerations, inflation and known increases in long-term contracts. • Capital expenditure for assets requiring replacement have been included in the budget. • Maintenance of infrastructure has been realistically budgeted for. • Borrowing repayments have been considered and included in the budget. • Expenditure is aligned to conditional grants received where this is applicable. • Budgeted expenditure are allocated to votes within the budget and the realistic allocation for the achievement of key performance indicators contained in IDP and SDBIP.

Strategic Focus Areas	Guidance For Audit Committee
Pricing of services Management should ensure that tariffs are realistic, in line with legislation and sufficient to meet operational and capital expenditure requirements.	• Audit Committees should confirm that the tariff policies as well as the tariff increases set by Management are in line with the IDP, SDBIP and Budget of the municipality. Management should ensure that the tariff increases are realistic and fair to the community and in line with legislation. • Management must consider the appropriateness of the municipalities pricing of services in the community it operates, given the historic late payments and bad debts. Management must review the forecasted prices for reasonability given forecasted inflation levels, ensure that overhead and treasury related costs are covered and ensure that the budgets and forecasts reflect these reasonable prices.
Working capital management In order to ensure long term financial sustainability, municipalities need to have a sufficient level of cash to meet its short term (expenses, creditors) and long term (loan and interest repayments) obligations.	• The audit committee should confirm that management has a suitable working capital strategy or cash flow management in place. • A suitable working capital strategy should enable the municipality to: - Enhance debts are collected timely and thereby reducing debtor's collection days. - Ensure that there is sufficient cash available to meet short term expenditure such as employee salaries and other operating expenses. - Ensure that there is enough cash to meet creditor obligations such as wholesale electricity purchased from Eskom within the stipulated 30 day payment period. - Ensure there is sufficient cash to meet interest and capital repayments on financing. - Ensure that salary deductions are paid over to the respective authorities.
Funding The municipality should ensure that there are sufficient funds to cover the budgeted expenditure, in some cases the municipality may need to borrow funds from external sources in order to fund capital expenditure over a long-term period.	**The audit committee should:** • Confirm whether funding is adequate to achieve the SDBIP and IDP. • Confirm whether Management have considered strategies to obtain funding from various sources at concessionary rates e.g. Municipal Infrastructure Grants. • Management must ensure that the following items have been addressed when long term funding is applied for: - Request and review the project business case from management. - Ensure that the project plan has been reviewed for reasonability. - Consider whether the proposed project initiation date is appropriate given the IDP, other projects and the available recourses. - Review the funding terms for reasonability and appropriateness and potential loan covenants for reasonability. - Ensure that the provisions of sections 46 to 48 of the MFMA are adhered in relation to long-term debt. More specifically, a municipality may only incur long term debt (in Rand only) and provide security for that debt obligation, if the debt is incurred to achieve the municipality's objects in term of section 152 of the Constitution. - Ensure the municipality complies with the conditions of the agreement. • Audit committees should confirm that the above items have been complied with.

Strategic Focus Areas	Guidance For Audit Committee
Investment strategy The municipality should ensure that there is an appropriate investment strategy to manage the municipalities excess cash.	• Review the investment policy for appropriateness of the types of investments, given risk appetite of the municipality. • Enquire whether management have a strategy in place to monitor investment returns and make changes to achieve the best risk-return for the municipality. • Monitor the application of the investment policy in its quarterly meetings.
Employees Management should ensure that employees are competent to perform their duties.	**Audit Committees should consider employment issues at a strategic level specifically management's response to the following:** • Vacancy rate especially for key employee positions. • Remuneration issues from a financial and compliance perspective specifically if there are any legislated bands of salaries. • Remuneration increase percentages which are higher than the percentages predetermined by Government. • The impact of operational risk issues related to labour e.g. lack of segregation of duties identified in audit findings. • Minimum competency requirements as regulated by National Treasury.
Supply chain management Management should ensure that procurement processes are in line with legislation and best practice	Audit committees should confirm whether the supply chain management processes are aligned to the Public Sector Supply Chain Management Framework issued by National Treasury. **Audit committees should ensure that management has performed the following:** • Reviewing the procurement plan and ensure that it aligns to the IDP, SDBIP and Budget. • Reviewing actual spending against the procurement plan and that government initiatives are being considered. • Broad Based Black Economic Empowerment is taken into account and complied with. • Establishing the validity of major goods and services acquired against the IDP and SDBIP.
Audit findings Management should ensure that audit findings are cleared	The audit committee has a responsibility to monitor that all internal and external audit findings are appropriately addressed by management and that corrective action is taken.
Reporting systems Management should ensure that accounting and performance management systems are adequate to ensure completeness and accuracy of financial information	• Audit committees should confirm whether Management has appropriately considered whether the accounting systems are adequate and updated. Management should ensure that the financial models used in making accounting estimates and in areas of complex management judgement, such as provisions and valuations of assets and liabilities are appropriate for its intended purpose. • Audit committees of municipalities should ensure that management has a performance management system in place that reports on the performance against the budget and forecasts of the municipality.

Strategic Focus Areas	Guidance For Audit Committee
Infrastructure maintenance Management should ensure that infrastructure remains operational	• Audit committee should confirm that management have reviewed the maintenance plan for appropriateness in light of the financial position, age and condition of the assets as well as the funding structure of the municipality.
Other	• Audit committees should confirm that management appropriately provided for bad debts and that that penalties and interest are levied on late payments and legal action is taken on long outstanding debtors. • Audit committees should confirm whether the municipality maintains an updated Indigent Register. The register measures the number of people in a specific geographic area who are eligible for rebates on certain municipal services. Having an up-to-date record of the population will ensure that budgeting for service delivery targets is accurate. An updated Indigent Register also ensures that the poorest members of the community are recipients of an equitable share of service delivery. • Audit committees should inform the auditor general of any fraud and/or corruption where management did not address it appropriately. Individuals found to be guilty of such offenses should be dismissed. • Review the report on unauthorised expenditure, irregular expenditure and fruitless and wasteful expenditure, obtain reasons for it, and assess improvements recommended to mitigate against the risk of such expenditure and monitor the effectiveness of controls management has put in place to eliminate these expenses and to deal with the open cases taking them to resolution.

6. Monitoring of the financial ratios, financial analysis and reporting

The quarterly report is the key document which audit committees will use to monitor the financial performance of the municipality. The report should include key financial ratios based on Circular 71. The report should contain:

- **Financial results of the municipality**
- **Revised forecasts**
- **Monitoring of key performance indicators or financial ratios**
- **Highlights and lowlights**
- **Scenario planning and sensitivity analysis**

In monitoring the key performance indicators, audit committees should have a robust understanding of what these financial ratios mean, how to interpret the ratio against the norm/benchmarks and be able to provide guidance to management on the appropriate action to be taken. Please refer to the table below for the purpose of each ratio, the ratio norm which will guide the audit committee in their analysis of the financial performance of the municipality. Please note that the norms need to be adjusted per municipality depending on the area, services provided, size and nature of the population and age and condition of the assets including infrastructure assets. The norm needs to be determined at the beginning of each IDP cycle, and explanations should be provided by management when a ratio falls outside the norm for review by the audit committee.

The ratios have been classified under the following focus areas:

1. Asset Management
2. Debtors Management
3. Liquidity Management
4. Liability Management
5. Sustainability
6. Efficiency
7. Distribution Losses
8. Revenue Management
9. Expenditure Management
10. Grant Dependency

Ratio	Norm	Formula	Data sources	How should the ratio be interpreted
1. Asset Management: Capital expenditure needed to ensure continued service delivery				
Capital expenditure to total expenditure ratio	**10-20%**	Total Capital Expenditure / Total Expenditure (Total Operating expenditure + Capital expenditure) × 100	Statement of Financial Position, Statement of Financial Performance, Notes to the AFS, Budget, In-Year reports, IDP and AR	Indicates the amount that the municipality is spending on new infrastructure– this should be in line with the terms of the budget, the age of the infrastructure as well as the asset management plan.
Impairment of PPE, Investment Property or Intangible Assets	**0%**	Property, Plant and Equipment Impairment + Investment Property Impairment + Intangible Assets Impairment/(Total Property, Plant and Equipment + Investment Property + Intangible Assets) × 100	Statement of Financial Position, Notes to the AFS and AR	Infrastructure assets should generate economic benefit and remain operational. If the infrastructure does not function as intended, the economic benefits are reduced and the asset should be impaired and this ratio will reflect the impairment percentage. The norm of 0% indicates that the assets are not impaired.
Repairs and maintenance as a % of Property, Plant and Equipment and Investment Property	**8%**	Total Repairs and Maintenance Expenditure/ Property, Plant and Equipment and Investment Property(Carrying value) x 100	Statement of Financial Position, Statement of Financial Performance, IDP, Budgets and In-Year Reports	Indicates that adequate repairs and maintenance are being performed on assets to ensure continued service delivery – this should be in line with the asset management plan and the age of the assets. A lower ratio indicates a lower level of service delivery due to the age of the assets and breakdown of assets. This will impact the need for future capital expenditure to replace assets that can no longer be maintained.

Ratio	Norm	Formula	Data sources	How should the ratio be interpreted
2. Debtors Management: Measures debt and revenue management which will ensure there is adequate working capital				
Collection rate	**95%**	(Gross Debtors Closing Balance + Billed Revenue - Gross Debtors Opening Balance + Bad Debts Written Off)/ Billed Revenue x 100	Statement of Financial Position, Statement of Financial Performance, Notes to the AFS, Budget , In-Year Reports, IDP and AR	Indicates quality credit control and revenue management – to improve the ratio a clear credit policy is required and a strict adherence to the policy should be promoted. In addition, an efficient debtor's collection department is one that actively manages overdue accounts and charges interest on overdue amounts. The consequence of not achieving this is that there is insufficient revenue to cover planned expenditure.
Bad debts written-off/ bad debts provided for	**0%**	Bad Debts Written-off / Provision for Bad Debt x 100	Statement of Financial Position, Statement of Financial Performance, Budget and AR	Indicates the level of bad debts written off versus bad debt provision. If the percentage exceeds 100%, it indicates that bad debts have not been sufficiently provided for.
Net debtors days	**30 days**	((Gross Debtors - Bad debt Provision)/ Actual Billed Revenue)) × 365	Statement of Financial Position, Statement of Financial Performance, Notes to the AFS, Budget and AR	Indicates the efficiency of collecting debtors. To improve the number of days, a review of the collection process and policy is needed, for example, further credit to long outstanding debtors should be stopped and legal action should be taken.
3. Liquidity management: Measures the cash needed to meet current operational expenses and debt obligations				
Cash/Cost coverage ratio	**1 to 3 months**	((Cash and Cash Equivalents - Unspent Conditional Grants - Overdraft) + Short Term Investment) / Monthly Fixed Operational Expenditure excluding (Depreciation, Amortisation, Provision for Bad Debts, Impairment and Loss on Disposal of Assets)	Statement of Financial Position, Statement of Financial Performance, Notes to the AFS, Budget, In year Reports and AR	Indicates that the municipality has adequate cash to meet its monthly fixed operational costs. To improve the ratio, overall working capital management should be improved.
Current ratio	**1.5 – 2.1**	Current Assets / Current Liabilities	Statement of Financial Position, Budget, IDP and AR	Indicates that there are adequate liquid assets to meet short term obligations. To improve a lower ratio, a municipality can increase the intensity of debtor collections.
4. Liability management: Measures the ability of the municipality to manage its debt levels optimally and ability to fund capital expenditure				
Debt / revenue	**45%**	(Overdraft + Current Finance Lease Obligation + Non Finance Lease Obligation + Short Term Borrowings + Long Term Borrowings) / Total Operating Revenue	Statement of Financial Position, Statement of Financial Performance, Budget, IDP and AR	Indicates that the current short and long term liability obligations can be met. To improve the ratio the municipality needs to improve its revenue collection management.
5. Sustainability: Measures the ability of the municipality to sustain its current and future operations				
Level of cash backed reserves	**100%**	(Cash and Cash Equivalents - Bank overdraft + Short Term Investment + Long Term Investment - Unspent grants) / (Net Assets – Accumulated Surplus – Non Controlling Interest - Share Premium - Share Capital - Fair Value Adjustment - Revaluation Reserve)	Statement Financial Position, Budget and AR	Indicates the percentage of contingent reserves which are available immediately in cash and cash equivalents.

Ratio	Norm	Formula	Data sources	How should the ratio be interpreted
6. Efficiency: Measures cost recovery				
Net operating surplus margin	**0%**	(Total Operating Revenue - Total Operating Expenditure)/Total Operating Revenue	Statement of Financial Performance, Budget, In-Year reports, AR, Statement of Comparison of Budget and Actual Amounts and Statement of Changes in Net Assets	Indicates that all cost associated with service delivery is recovered and a ratio greater than 0% indicates that the municipality has surplus funds for future capital funding requirements. To improve the ratio, the municipality needs to improve its revenue management, specifically revise its tariffs to ensure that costs are covered, and reduce operating and fixed costs by re-assessing the efficiency of its processes. In addition, variance analysis against budget and prior periods will assist to identify the potential reasons for the deficit.
Net surplus/deficit of electricity	**0% to 15%**	Total Electricity Revenue less Total Electricity Expenditure/Total Electricity Revenue × 100	Statement of Financial Performance, Notes to AFS, Budget, IDP, In-Year reports and AR	Indicates that the municipality is recovering all the costs associated with the delivery of electricity. To improve the ratio, the municipality needs to improve its revenue management, negotiate for lower costs from the electricity producers and/or address abnormal losses due to theft or leakage.
Net surplus/deficit of water, refuse, sanitation and waste	**0% or greater**	Total Water Revenue less Total Water Expenditure/ Total Water Revenue × 100	Statement of Financial Performance, Budget, IDP, In-Year reports and AR	Indicates that all cost associated with the service are recovered and a greater ratio indicates that the municipality has surplus funds to address future operational and capital funding requirements. To improve the ratio, the municipality needs to consider improving its revenue management, aim to decrease the cost of acquiring the service from the supplier, address any abnormal losses and negotiate lower prices with the supplier.
7. Distribution Losses: Revenue losses which occur due to illegal connections, burst water pipes and water leakages				
Electricity Distribution Losses (Percentage)	**Below 7% to 10%**	(Number of Electricity Units Purchased and/or Generated - Number of Electricity Units Sold) / Number of Electricity Units Purchased and/or Generated) × 100	Annual Report, Audit Report and Notes to Annual Financial Statements	Indicates that electricity losses are well managed. To improve the ratio, timeous readings of meters should occur, readings should not be estimated, electricity infrastructure should be improved to curb illegal connections, improve management, planning and design of networks so that electricity wastage would not occur, monitor high risk areas where illegal connections and theft are likely to occur, install prepaid meters in areas where non-payment occurs, implement staff awareness programmes and public awareness campaigns.
Water Distribution Losses (Percentage)	**A ratio below 15% to 30%**	(Number of Kilolitres Water Purchased or Purified - Number of Kilolitres Water Sold) / Number of Kilolitres Water Purchased or Purified × 100	Annual Report, Audit Report and Notes to Annual Financial Statements	Indicates that water losses are well managed. To improve the ratio: timeous readings of meters should occur, readings should not be estimated, water infrastructure should be improved so as to avoid water leakages, monitoring of high risk areas where illegal connections and theft is likely to occur, continuous monitoring of areas to prevent water leakages occurring as a result of burst pipes etc. and analysis of losses against the budget regularly, divide entire municipal area into smaller manageable water supply zones. Undertake a systematic leak detection and repair programme on the water reticulation system, the installation of a water meter is to monitor and control the provision of water services and to improve the efficiency of billing.

Ratio	Norm	Formula	Data sources	How should the ratio be interpreted
8. Revenue management: Refers to methods to increase revenue by increasing the number of active accounts and improving revenue collection procedures				
Growth in Number of Active Consumer Accounts	**No norm**	(Period under review's number of Active Debtor Accounts - previous period number of Active Debtor Accounts)/ previous period number of Active Debtor Accounts x 100	Debtors System	To improve the ratio a customer analysis in areas, service delivery needs analysis should be undertaken. Municipalities also need to attract new businesses and engage with potential customers and implement customer awareness programmes.
9. Expenditure management: Refers to cost containment strategies to limit irregular and fruitless expenditure and to manage increases in controllable operating expenses				
Remuneration as % of Total Operating Expenditure	**25% and 40%**	Remuneration (Employee Related Costs and Councillors' Remuneration) / Total Operating Expenditure x100	Statement of Financial Performance, Budget, IDP, In-Year reports and AR	To improve the ratio, a review of skills required and job specifications should be performed to address inefficiencies, the municipality should provide training, appoint employees with the required skills and implement a proper remuneration policy and performance management system.
10. Grant Dependency: under-resourced municipalities are dependent on grants and subsidies in order to deliver services to their communities				
Own Funded Capital Expenditure (Internally Generated Funds + Borrowings) to Total Capital Expenditure	**No norm**	Own funded Capital Expenditure (Internally generated funds + Borrowings) / Total Capital Expenditure x 100	Statement of Financial Position, Budget, AFS Appendices, Notes to the Annual Financial Statements (Statement of Comparative and Actual Information), Budget, IDP, In-Year reports and AR	This ratio should be in line with the funding plan. To improve the ratio, the municipality should improve it revenue management, reduce its expenditure and apply for increased grants from local and international organizations.
Own Funded Capital Expenditure (Internally Generated Funds) to Total Capital Expenditure	**No norm**	Own funded Capital Expenditure (Internally Generated Funds) / Total Capital Expenditure x 100	Statement of Financial Position, Budget, AFS Appendices, Notes to the Annual Financial statements (Statement of Comparative and Actual Information) Budget, IDP, In-Year reports and AR	No norm is proposed at this time although the ratio should improve over time. To improve the ratio, the municipality should increase its net operating margin and set a more accurate capital budget.
Own Source Revenue to Total Operating Revenue (Including Agency Revenue)	**No norm**	Own Source Revenue (Total revenue - Government grants and Subsidies - Public Contributions and Donations)/ Total Operating Revenue (including agency services) x 100	Statement Financial Performance, Budget, IDP, In-Year reports and AR	No norm is proposed at this time. To improve the ratio, an analysis of the trends and levels of own source of revenue should also inform the municipality to optimise its own revenues. The ratio measuring own source revenue should increase over time as it reflects municipal efforts towards self-sufficiency.

7. Conclusion

This document is a guide to assist audit committee members in performing their responsibilities effectively in regards to the financial analysis of the municipality. Audit committee members have an additional resource to assist them in the analysis of the financial performance of these entities. This document is part of the toolkit to provide guidance on the types of corrective action to be taken to ensure the financial sustainability of municipalities so that they are able to meet their service delivery obligations.

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Institute of Directors in Southern Africa
PSACF Secretariat

National Office - Johannesburg | PO Box 908, Parklands 2121 | Johannesburg, South Africa

144 Katherine Street, Sandown, Sandton 2196

Tel: 011 430 9900 | Fax: 011 444 7907 | Email: IoDSA@IoDSA.co.za | Web: www.IoDSA.co.za