

**NATIONAL TREASURY
PPP MANUAL
MODULE 7: AUDITING PPPs**

**NATIONAL TREASURY PPP PRACTICE NOTE
NUMBER 08 OF 2004**

In accordance with section 76(4)(g) of the Public Finance Management Act, 1999 (PFMA), National Treasury may issue instructions to institutions to which the PFMA applies in order to facilitate the application of the PFMA and the regulations promulgated under the PFMA.

This National Treasury PPP Practice Note Number 08 of 2004 'Auditing PPPs' applies to departments, constitutional institutions, public entities listed or required to be listed in schedules 3A, 3B, 3C and 3D to the PFMA, and subsidiaries of such public entities.

Extract from Treasury Regulation 16 to the PFMA

16.7 *Management of PPP agreements*

16.7.1 *The accounting officer or accounting authority of the institution that is party to a PPP agreement is responsible for ensuring that the PPP agreement is properly implemented, managed, enforced, monitored and reported on, and must maintain such mechanisms and procedures as approved in Treasury Approval: III for –*

- (a) measuring the outputs of the PPP agreement;*
- (b) monitoring the implementation of the PPP agreement and performances under the PPP agreement;*
- (c) liaising with the private party;*
- (d) resolving disputes and differences with the private party;*
- (e) generally overseeing the day-to-day management of the PPP agreement; and*
- (f) reporting on the PPP agreement in the institution's annual report.*

16.7.2 *A PPP agreement involving the performance of an institutional function does not divest the accounting officer or accounting authority of the institution concerned of the responsibility for ensuring that such institutional function is effectively and efficiently performed in the public interest or on behalf of the public service.*

16.7.3 *A PPP agreement involving the use of state property by a private party does not divest the accounting officer or accounting authority of the institution concerned of the responsibility for ensuring that such state property is appropriately protected against forfeiture, theft, loss, wastage and misuse.*



NATIONAL
TREASURY
PPP

unit

PPP PROJECT CYCLE

Reflecting Treasury Regulation 16 to the
Public Finance Management Act, 1999

PPP Manual reference

PROJECT PREPARATION PERIOD

PROJECT TERM

Phase I

INCEPTION

- Register project with the relevant treasury
- Appoint project officer
- Appoint transaction advisor

Phase II

FEASIBILITY STUDY

Prepare a feasibility study comprising:

- Needs analysis
- Options analysis
- Project due diligence
- Value assessment
- Economic valuation
- Procurement plan

Treasury Approval: I

Phase III

PROCUREMENT

- Design a fair, equitable, transparent, competitive, cost-effective procurement process
- Prepare bid documents, including draft PPP agreement

Treasury Approval: IIA

- Pre-qualify parties
- Issue request for proposals with draft PPP agreement
- Receive bids
- Compare bids with feasibility study and each other
- Select preferred bidder
- Prepare value-for-money report

Treasury Approval: IIB

- Negotiate with preferred bidder
- Finalise PPP agreement management plan

Treasury Approval: III

PPP agreement signed

Phase IV

DEVELOPMENT

- Measure outputs, monitor and regulate performance,

Phase V

DELIVERY

- liaise effectively, settle disputes
- Report progress in the Annual Report

Phase VI

EXIT

- Scrutiny by the Auditor-General

Module 1

Module 2

MODULE 3

Module 6

Module 1

Module 2

MODULE 4

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Module 7

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Module 9

Module 1

Module 2

Module 4

MODULE 5

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Module 1

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ABOUT THIS MODULE

Module 7: Auditing PPPs describes the powers and functions of the Auditor-General, and the scope of financial, performance and forensic audits. It explains how this applies to PPPs, particularly in relation to the management of the PPP agreement. It also outlines the role of the institution's internal audit unit in PPP projects.

The Module has been compiled by National Treasury in co-operation with the Office of the Auditor-General.

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INTRODUCTION

The auditing of PPPs regulated by Treasury Regulation 16 to the PFMA is done in terms of the Public Finance Management Act, 1999 (PFMA) and the Auditor-General Act, 1995, founded on the relevant provisions of the Constitution, 1996.

While a PPP changes the means of delivering services, and the use of state property may change hands, the institution is still accountable for ensuring that services are delivered or that state property is used properly.

Not only is sound financial management required by law, but the accounting officer/authority is required to follow regulations precisely and to be able to account for administrative processes and expenditure. These are fundamental features of good governance, and the institution will be audited accordingly.

THE AUDITOR-GENERAL

The powers and functions of the Auditor-General

The Auditor-General can be regarded as an independent auditor acting on behalf of taxpayers, and auditing and reporting on the activities of all government institutions.

The powers and functions of the Auditor-General are set out in the Constitution of the Republic of South Africa, 1996, the Auditor-General Act, 1995. (See Annexure 1: 'Section 188 of the Constitution of the Republic of South Africa Act, 1996', and Annexure 2: 'Extracts from Section 3 of the Auditor-General Act, 1995'.) Specific auditing procedures and requirements are set out in the PFMA in respect of national and provincial institutions.

The Auditor-General audits all the accounts and regulatory compliance of all accounting officers/authorities of all spheres of government, and of all other persons in the national, provincial or municipal services entrusted with public assets and trust property, and reports the results to Parliament or the relevant provincial legislature.

All these reports must be made public. This is essential for transparency and accountability – the guiding principles of the Office of the Auditor-General.

The Auditor-General must express an opinion on:

- whether or not the financial statements of the institution, in all material respects, fairly present the results of the institution's operations in accordance with the prescribed accounting practice; and
- whether or not any transactions comply with the laws and regulations which apply to financial matters.

The scope of the Auditor-General's audits

The Auditor-General will determine the scope of any audit, but all entail comprehensive auditing, whether they are regularity audits, performance audits, forensic audits or any other audits.

Regularity auditing

Regularity audits are conducted annually for all institutions. These involve both compliance and financial auditing:

- **Compliance auditing**

Compliance auditing is an independent external evaluation of the extent to which an institution complies with any legislation, regulations, policy, control measures, procedures, motivations and authorisations related to financial matters and which apply to the institution. A compliance audit includes an examination, on a test basis, of the evidence supporting compliance.

- **Financial auditing**

Financial auditing is an independent external evaluation of accounting systems and of samples taken from evidence transactions, to form an objective opinion on the following questions:

- Do the institution's financial statements, together with their notes, fairly and materially present the institution's financial position at a particular date, and fairly represent the results of its operations and cash flow for the period, in accordance with the identified reporting framework?
- Are these statements in conformity with generally accepted accounting practice, and do they comply with legal requirements?
- Are all income, expenditure, assets and liabilities recorded and accounted for?
- Are the institution's accounting records accurate, complete, and of high quality?
- Is there sufficient and acceptable documentation for all authorised expenditure?
- Has revenue been collected properly?
- Are sufficient and applicable internal control procedures, which are essential for sound financial management, in place and maintained?

In terms of the PFMA, the Auditor-General must audit the institution's financial statements and submit a report within two months of receiving the statements. Within five months of the end of a financial year, the following are submitted to the relevant treasury:

- the audited financial statements of the institution
- the Auditor-General's report on those statements
- the institution's annual report.

A department or public entity must also submit these to the responsible executive authority. The costs of regularity audits are budgeted for by the institution.

Performance auditing¹

Performance auditing is about management practices and the use of resources. Although these are, to some extent, covered in the annual regularity audit, in addition the Auditor-General conducts performance audits. These may take the form of specific focus reports.

Subsection 3(4)(d) of the Auditor-General Act requires that the Auditor-General should be reasonably satisfied that 'satisfactory management measures have been taken to ensure that resources are procured economically and utilised effectively and efficiently'. The Auditor-General must report to the legislative bodies concerned if the utilisation of resources is uneconomical, inefficient or ineffective, or if the use of resources is not in the best interests of the state or statutory body concerned.

Performance audits can be conducted by the Auditor-General on a cyclical basis should the Auditor-General determine it necessary. The institution itself may also request performance audits.

1. See 'Annexure 2: Extracts from Section 3 of the Auditor-General Act, 1995'.

The cost of a performance audit is borne by the institution or the relevant treasury, as agreed before the audit is carried out.

Forensic auditing

If at any stage during regularity auditing or performance auditing, the Auditor-General suspects that fraud or corruption may have been committed in respect of any aspect of the institution's financial affairs, the Auditor-General may institute a forensic audit. This forensic audit may be conducted by the Office of the Auditor-General itself, or may be outsourced to a private company specialising in such audits. A forensic audit may be instituted by the Auditor-General, or may be requested by the institution.

The cost of forensic auditing is borne by the institution concerned.

How does this apply to PPPs?

Providing information as required by the law

Treasury Regulation 16.7 explicitly requires that **the institution's accounting officer/authority reports on the management of the PPP agreement in the institution's annual report.**² The scope of this report is prescribed by the PFMA – specifically section 40 for accounting officers, and section 55 for accounting authorities – and it is audited by the Auditor-General.

In auditing the annual report of the institution, the Auditor-General will review the information presented to ensure that it is not inconsistent or does not contradict the information in the audited financial statements.

Institutions must ensure that the PPP agreement contains adequate provisions for allowing the institution access to all necessary information about the PPP which is in the private party's hands. A standard clause for this purpose is provided in *Standardised PPP Provisions* Part P:75 and should be applied accordingly.

The standard clause is provided because a private party to a PPP agreement must be under an ongoing obligation to disclose to the institution all the information that the institution may reasonably require for it to fulfil its financial reporting obligations. This must extend, for example, to providing for the institution's disclosure obligations under other legislation, such as the Promotion of Access to Information Act, 2000 and legislation governing health and safety and the environment.

In devising the necessary reporting arrangements in a PPP agreement, institutions should note that, in terms of the Auditor-General Act, the Auditor-General has the discretion to:

- determine the nature and extent of any audit carried out by it (s3.3)
- investigate whether any property or any other assets of an institution, including any institution assets, are being used efficiently and effectively (s5(b)(ii))

². See *Module 6: Managing the PPP Agreement*.

- investigate any matter relating to expenditure on the part of the institution (s5(b)(ii))
- publish details of the use of the assets or resources of an institution and of its expenditure which the Auditor-General determines is uneconomical, inefficient, ineffective or detrimental, including commenting on and publishing any issues that arise in relation to performance.

In addition to the reporting obligations in respect of the PPP agreement itself, the institution must meticulously keep records of all processes and decisions and expenditures in respect of the inception, feasibility and procurement phases of the PPP project cycle for audit purposes.

The compliance audit component of the regularity audit

As part of the regularity audit of an institution, the Auditor-General will determine whether the institution (the auditee) is involved in any PPP projects. Once a PPP project is identified, specific compliance auditing begins, and the Auditor-General will seek to verify whether or not the requirements of the PFMA and Treasury Regulation 16 have been met. Existing PPP agreements with private parties as well as future contemplated PPP agreements will be evaluated against the characteristics of PPP agreements defined by Treasury Regulation 16.

The audit procedures will be determined by the phase at which the project is in the PPP project cycle.

Registration of the project with the relevant treasury, appointment of the project officer and transaction advisor (Phase 1: Inception)³

The Auditor-General will establish whether or not the project was registered as prescribed, and whether or not a suitable project officer and transaction advisor (the latter if required by the relevant treasury) have been appointed by the institution.

Treasury approvals⁴

The Auditor-General needs to be satisfied that the relevant treasury has granted the written approvals which apply to the various stages of the PPP project cycle as prescribed by Treasury Regulation 16:

- Were formal Treasury approvals I, IIA, IIB and III obtained from the relevant treasury (Treasury Regulation 16.4, 16.5, 16.6)?
- If any of these approvals was granted conditionally, have all the conditions been complied with to the satisfaction of the relevant treasury?
- Were any other approvals necessary in terms of Treasury Regulation 16 prior to Treasury Approval: III, specifically relating to any changes to the feasibility study assumptions (Treasury Regulation 16.4.4)?

3. See *Module 3: PPP Inception* for details on the appointment of the project officer and the transaction advisor.

4. See *Module 4: PPP Feasibility* for detailed information on TA:I and *Module 5: PPP Procurement* for TA:II and TA:III.

- Has the accounting officer/authority established mechanisms and procedures for properly managing a PPP agreement (Treasury Regulation 16.7)?
- Has any material amendment or variation to a PPP agreement obtained the necessary treasury approval (Treasury Regulation 16.8)?

The financial audit component of the regularity audit

According to the specimen annual financial statements issued by National Treasury for provincial and national departments, the institution is required to include in the 'Notes to the annual financial statements', for each PPP the institution has entered into, the following information:

- a description of the project
- significant terms of the PPP agreement that may affect the amount, timing and certainty of future cash flows
- the nature and extent of:
 - rights to use specified assets
 - obligations to provide or rights to expect the provision of services
 - obligations to acquire or build items of property, plant and equipment
 - obligations to deliver or rights to receive specified assets at the end of the concession period
 - renewal and termination options
 - other rights and obligations (for example major overhauls)
- changes in the terms of the PPP agreement that may occur during the period of reporting.

Is the note correct?

Given that the Auditor-General needs to express an audit opinion on the 'Notes to the annual financial statements', the note on PPPs will be subjected to the normal audit process. To determine whether the note is correct in all material respects, supporting information and evidence will need to be obtained from the accounting officer/authority. The accounting officer/authority is therefore required to keep all documentation related to PPP agreements, including information from all stages of the PPP project cycle and all project information and supporting documentation that will have an impact on the financial statements.

What is the financial impact on the institution of the PPP agreement?

The Auditor-General will also consider the financial impact of the PPP agreement. The Auditor-General will therefore have to get an overall understanding of the agreement, specifically those conditions with a financial impact, to be able to evaluate both the accounting treatment applied, and the institution's compliance with the specific requirements of the PPP agreement.

Should the institution account for any project assets or resources?

From the specific PPP agreement, the Auditor-General will consider whether the institution should account for any project assets or resources. The accounting

treatment of these items needs to be in accordance with the institution's accounting policy and the directives of the Accountant-General.⁵

Performance audits

The Auditor-General may conduct performance audits on any aspect of a PPP – for example, of the appropriateness of the feasibility study – and the accounting officer/authority will be required to provide all the relevant supporting documentation. Another example is that the Auditor-General may conduct a performance audit after the PPP agreement has been signed and operations have begun to evaluate the long-term affordability of the PPP or to determine whether it provides value for money by measuring the actual outputs against those specified in the PPP agreement.

Forensic audits

The Auditor-General may conduct a full forensic audit on any aspect of a PPP if fraud or corruption is suspected. For example, a forensic audit will be conducted into any or every aspect of the PPP procurement process if foul play is suspected. This would include an audit of all procurement procedures followed, by detailed examination of documents, and by interviews with all relevant participants. Criminal and/or disciplinary procedures would follow against relevant parties if the Auditor-General reported findings indicating fraud or corruption. As with all reports of the Auditor General, the forensic audit report would be made public.

The Auditor-General's report

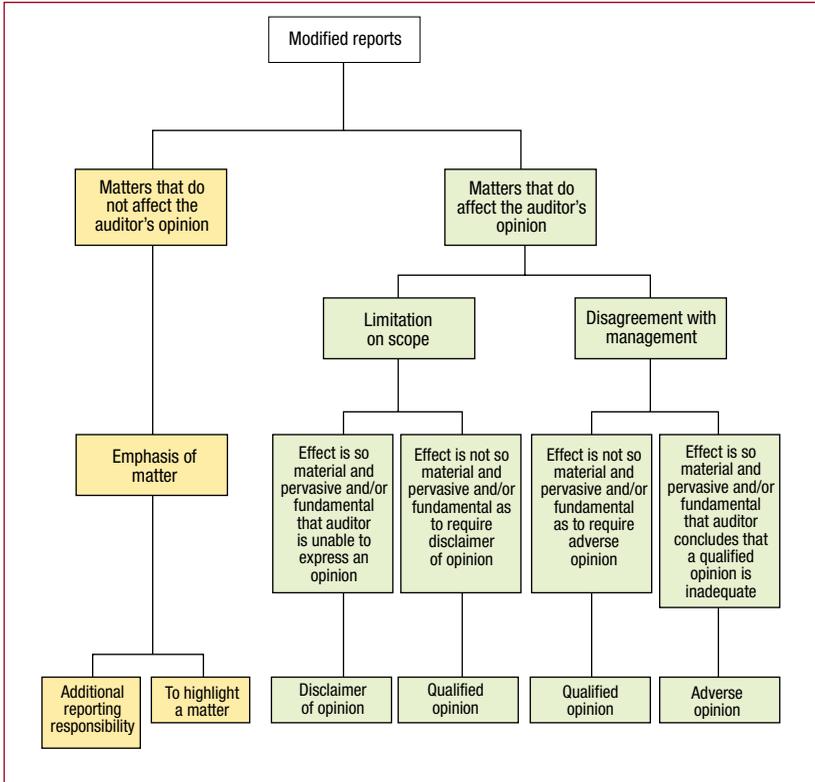
The Auditor-General's report on an institution is submitted to Parliament or the relevant legislature with the institution's (the auditee's) financial statements and annual report. The Auditor-General may issue a report either as:

- An unqualified report on the institution; or
- A modified report (which may contain either a qualification, adverse opinion, or a disclaimer of opinion).

The options for modified reports issued by the Office of the Auditor-General are illustrated here.

5. See *Module 8: Accounting Treatment for PPPs*.

Figure 7.1 Formats of modified reports issued by the Office of the Auditor-General



Special audit reports, such as performance audits and forensic audits, are not included in the institution's annual report to Parliament or to the relevant legislature, but a reference to the existence of such special audit reports is made in the annual report. Special audit reports are summarised in the portfolio summary of the General Report of the Auditor-General and are available to the public.

INTERNAL AUDIT

Internal auditing can be defined as the independent review function within the institution.

The objective of the internal audit function is to assist the executive and management of an institution by providing them with information and advice. An institution's internal audit unit is responsible for this function.

Treasury Regulation 3 to the PFMA sets out the requirements for establishing an audit committee and the roles and functions of the internal audit unit. The purpose, authority and responsibility of this audit committee must be formally defined in an institution's audit charter. The regulation provides that the internal audit unit may be partly or wholly contracted to an external organisation with specialist audit expertise.

Scope of internal audit

The scope of the internal audit function is broadly defined as:

- **Risk management:** The internal audit unit identifies, evaluates and assesses significant risk management methodologies and controls, including a fraud prevention plan.
- **Internal controls:** The internal audit unit provides an independent evaluation of the adequacy of internal controls to determine their effectiveness and efficiency, and develops new controls and provides recommendations for improving the existing controls. The controls should encompass the information systems environment, the reliability of financial and operational information, the effectiveness of operations, the safeguarding of assets, and compliance with laws, regulations and controls.
- **Governance:** The internal audit unit evaluates and develops systems for improving the process through which objectives and values are established and communicated, the accomplishment of objectives is monitored, accountability is ensured, and corporate values are preserved.

Internal audit plans are required by Treasury Regulation 3 to comprise:

- **a rolling three-year strategic internal audit plan**, based on the unit's assessment of key areas of risk for the institution, and bearing in mind the institution's current operations, those proposed in its strategic plan, and its risk management strategy
- **an annual internal audit plan** for the first year of the rolling three-year strategic internal audit plan
- **plans indicating the proposed scope of each audit** in the annual internal audit plan
- **a quarterly report to the audit committee** detailing the unit's performance against the annual internal audit plan, to allow effective monitoring and possible intervention.

The responsibility for the adequacy and reliability of internal controls rests entirely with the management of the institution – the accounting officer/authority in terms of s38(1) and s51(1) respectively of the PFMA. The internal audit unit thus reports directly to the accounting officer/authority.

Effective communication between the internal audit unit and the Office of the Auditor-General is necessary to attain optimal audit coverage. As part of its work, the Auditor-General will consider the activities of the internal audit and its effect on external audit procedures. An effective internal audit unit may prompt the Auditor-General to follow a ‘control test’ approach rather than a substantive route to its regularity and performance audits.

The role of internal audit in PPPs

From the date a PPP is registered with the relevant treasury, the internal audit unit should include the PPP in its audit plans and reports, and should present these for approval to the audit committee. The internal audit unit will need to develop a specific and appropriate approach for reviewing a PPP under each of its areas of responsibility.

In terms of these audit plans, the PPP project officer should be required to ensure that the PPP’s document management and decision-making system is in keeping with the risk management, internal controls and governance standards set by the internal audit unit and endorsed by the audit committee. The project officer and the project secretariat should be required to maintain these standards throughout the PPP project cycle, from inception phase, through the feasibility and procurement phases, and throughout the term of the PPP agreement.

Due to their size and complexity, PPPs are at risk of being affected by some corrupt activity, or at least by the harmful perception that corrupt activity is occurring. The accounting officer/accounting authority is therefore advised by National Treasury to sign off on an anti-corruption policy for a PPP project, with clear requirements and processes for calling for forensic audits if fraud or corruption are suspected, and for dealing swiftly with any corrupt activities by project team members or bidders.

In particular, the PPP procurement plan and the bid process must have built-in safeguards of disclosure, a code of conduct⁶, and structured oversight – specifically, the oversight of at least the internal audit component, and on larger projects, the oversight of an external auditor as well.

6. See *Module 5: PPP Procurement: ‘Annexure 2: Template code of conduct for bid evaluation panel members’ and ‘Annexure 3: Template declaration of interest statement’*.

ANNEXURES

ANNEXURE 1

Section 188 of the Constitution of the Republic of
South Africa, 1996

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ANNEXURE 2

Extracts from Section 3 of the Auditor-General Act, 1995

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SECTION 188 OF THE CONSTITUTION OF THE REPUBLIC OF SOUTH AFRICA, 1996

- (1) *The Auditor-General must audit and report on the accounts, financial statements and financial management of*
 - (a) *all national and provincial state departments and administrations,*
 - (b) *all municipalities; and*
 - (c) *any other institution or accounting entity required by national or provincial legislation to be audited by the Auditor-General.*
- (2) *In addition to the duties prescribed above, and subject to any legislation, the Auditor-General may audit and report on the accounts, financial statements and financial management of –*
 - (a) *any institution funded from the National Revenue Fund or a Provincial Revenue Fund or by a municipality; or*
 - (b) *any institution that is authorised in terms of any law to receive money for a public purpose.*
- (3) *The Auditor-General must submit audit reports to any legislature that has a direct interest in the audit, and to any other authority prescribed by national legislation. All reports must be made public.*
- (4) *The Auditor-General has the additional powers and functions prescribed by national legislation.*

EXTRACTS FROM SECTION 3 OF THE AUDITOR-GENERAL ACT, 1995

3. Functions of the Auditor-General

- (1) *The Auditor-General shall, in addition to the powers and functions conferred upon or entrusted to him or her in terms of section 193 of the Constitution, have the powers and perform the duties specified in the Act.*
- (2) *Notwithstanding the provisions of any other law but subject to the provisions of the Constitution, the Auditor-General shall perform the functions vested in him or her by virtue of any other law, in accordance with the provisions of the Auditor-General Act in relation to –*
 - (a) *the accounts which shall be audited;*
 - (b) *the procedure according to which auditing shall be done; and*
 - (c) *the steps to be taken by the Auditor-General as a result of an audit.*
- (3) *The Auditor-General may at his or her discretion determine the nature and extent of the audit to be carried out and request the details and statements of account which he or she considers necessary, provided that he or she may, notwithstanding the provisions of any other law, also determine the format in which and the date on which such details, statements of account and financial statements shall be submitted to him or her.*
- (4) *The Auditor-General shall reasonably satisfy himself or herself that:*
 - (a) *reasonable precautions have been taken to safeguard the proper collection of money to which an audit in terms of this Act relates, and that the laws and instructions relating thereto have been duly observed;*
 - (b) *reasonable precautions have been taken in connection with the receipt, custody and issue of, and accounting for, property, money, stamps, securities, equipment, stores, trust money, trust property and other assets;*
 - (c) *receipts, payments and other transactions are made in accordance with the applicable laws and instructions and are supported by adequate vouchers; and*
 - (d) *satisfactory management measures have been taken to ensure that resources are procured economically and utilised efficiently and effectively.*

