EXPLANATORY NOTE ON PUBLIC AUDIT EXCESS FEE BILL [B 7-2019]

Prepared by National Treasury

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1. The purpose of the Public Audit Excess Fee Bill (the Audit Excess Fee Bill - is to provide that audit fees in excess of 1% of current and capital expenditure (the excess audit fee) of qualifying auditees audited by the Auditor-General (AG) is a direct charge against the National Revenue Fund (NRF). National and provincial departments and government components are excluded from this provision. A money Bill, tabled by the Minister of Finance, is required for a direct charge against the NRF.

2. The proposed direct charge for the excess audit fee results from a joint proposal by the AG and NT to the Standing Committee on the Auditor-General of the National Assembly during its deliberations on the Public Audit Amendment Bill, initiated by that Committee. The Public Audit Amendment Bill (now an Act) contains the details of when an excess audit fee will become a direct charge.

3. The Public Audit Amendment Bill was passed by Parliament and assented to by the President in 2018. The Public Audit Amendment Act, 2018 (Act No 5 of 2018) was published in the Gazette on 20 November 2018 – **Annexure A**. It is to take effect on a date determined by proclamation by the President.

4. Funding arrangements of the AG

4.1 The primary function of the AG is to conduct regulatory audits, performance auditing and special investigations in terms of the Constitution and the Public Audit Act, 2004 (**Annexure B**). The AG is funded through fees charged to auditees that receive audit and audit related services from the AG. Though the AG may be funded by an appropriation by Parliament, it does not receive appropriated funds currently (sections 23 and 36 of the Public Audit Act).

4.2 The audit fees are used to cover the AG's expenses, finance the fixed assets and generate a surplus, which ranges from 1% to 4% for working capital and general reserve requirements. Fees are based on the hours worked on auditee projects (audits) based on published tariff rates per salary level of all audit staff. This means that unpaid audit fees deprive the AG of much needed cash flow to support the execution of its constitutional mandate.

4.3 A substantial amount of the AG's revenue (or 10% of its client base) falls in the so called financially distressed category. These auditees are predominantly low capacity municipalities and small auditees such as museums, trusts and boards. These fees are uncollectable and puts the AG's financial viability at serious risk. Contrary to private audit firms that have the benefit of walking away from a non-paying client, the AG is constitutionally required to perform annual audits and may not terminate a client's services.

4.4 Currently the Public Audit Act provides in section 23(6) that if the audit fee for is in excess of 1% of the current and capital expenditure of the auditee, then the excess must be defrayed from the NT's vote if NT is of the view that the auditee has financial difficulty to pay the excess. This provision does not apply to national and provincial departments – they must pay the full audit fee, even if it exceeds 1% of its current and capital expenditure.

4.5 The performance of the extended powers of AG in the Public Audit Amendment Act, 2018, will be funded through an appropriation and not through audit fees. The first of these extended powers enables the AG to refer suspected material irregularities to a relevant public body for investigation. A further extended power authorises the AG to make recommendations in an audit report on ways to remedy a material irregularity. Failure to implement these recommendations is followed by binding remedial action. Further failure to abide by the remedial action taken by the AG leads to the issuing of a certificate of debt against an accounting officer or members of an accounting authority, in their personal capacity, in the event that a financial loss had been suffered. Once a certificate of debt has been issued, the recipient thereof becomes a debtor to the State. The relevant executive authority is charged with the responsibility to recover the amount stipulated in the certificate and must deposit such amount in the relevant revenue fund.

5. Reasons for proposed direct charge for excess audit fee

5.1 Historically, the excess audit fee to be paid from NT's vote was much higher than the amount appropriated for NT and resulted in shortfalls. The details for 2014/15, 2015/16 and 2016/17 financial years are as follows:

Financial year	Amount claimed by AG (R'million)	Amount appropriated by NT (R'million)	Additional funds made available by NT (R'million)	Shortfalls (R'million)
2014/15	127.02	41.86	20.00	(65.17)
2015/16	154.86	44.08	-	(110.79)
2016/17	169.33	46.28	35.00	(88.05)
TOTAL	451.21	132.21	55.00	(264.00)

The continued short falls in respect of 1% debt came to a point where the financial viability of the AG was at risk, which could have easily spilled over to a threat to its constitutional independence.

5.2 Given the AG's constitutional obligation to audit national and provincial departments, municipalities, municipal entities and specified public entities, it should have certainty about its funding. The vote of the NT has to fund not only the Treasury's own operations, but several other competing priorities and these competing priorities make it virtually impossible to estimate such funding accurately. Furthermore, the unpredictability of the total annual excess audit fee creates challenges for the particular vote (i.e. that of NT) and it may result in NT not regarding an affected institution being in financial difficulty merely to limit payment from its vote which in turn may result in a dispute with the AG and undermine its independence. The latter effectively means that a further risk arises, namely that NT may apply its own criteria for financial distress inconsistently, which increases the risk of litigation against it.

5.3 Given the crucial role that the AG plays in ensuring constitutional democracy, the State should ensure that this institution remains financially independent and free from undue influence. The defrayment of excess audit fees of financially distressed auditees audited by AG, as a direct charge, will significantly enhance its ability to perform its functions without fear, favour or prejudice.

6. Determination of audit fees

6.1 The Public Audit Act, as to be amended by the Public Audit Amendment Act, requires that the AG annually consults NT on-

(a) the frequency, nature and scope of audits to facilitate the determination of audit fees; and

(b) the basis of the calculation of the audit fees.

6.2 The Public Audit Act, as to be amended by the Public Audit Amendment Act, also requires the AG and NT to agree in writing on-

(a) the annual date of consultation on matters mentioned in paragraph 6.1;

(b) the criteria to apply to determine whether an auditee has financial difficulty to pay the excess audit fee; and

(c) a process to determine an estimate of funds required annually as a direct charge for excess audit fees.

If a deadlock arises, the Standing Committee on the Auditor-General must determine the above matters.

7. Why a direct charge?

7.1 The direct charge in this instance will mean that the payment to the AG will not form part of the normal appropriation of funds to the NT. The payment will be made directly from the NRF to the AG, by the Office of the Accountant-General (OAG) that is responsible for managing the NRF.

7.2 The NT (through the OAG) will be responsible for ensuring that an appropriate amount is budgeted as part of the annual budget to provide for the payment of a direct charge. Such amount will be indicative only, as the final payment will be in line with the agreed payment after concluding the process for calculating the total amount of the direct charge.

7.3 A direct charge instead of increasing the appropriation for excess audit fees on NT's vote is proposed since the annual amount varies every year and in current fiscal position of the country, will require NT to cut from other items on its own budget and impacts negatively on NT's ability to perform its own functions. A direct charge will mean revenue in NRF contributes directly to those auditees unable to pay the excess audit fee. It limits disputes between the AG and NT and creates more certainty for the AG of what the expected revenue would be. Such certainty is vital for accurate budgeting and prioritisation of objectives. Furthermore, certainty of anticipated revenue is critical for financial independence, one of the key pillars of a truly independent supreme audit institution.

7.4 Transparency on direct charges exists in that the amount will appear in Estimates of National Expenditures for NT when the budget is tabled in Parliament.

7.5 The scope for qualifying auditees to abuse the provision for direct charge for excess audit fees is curtailed by retaining the requirement that the NT must first determine that the institution has financial difficulty to pay the excess audit fee and strengthening the process on scope, nature and frequency of audits and the determination of the basis of calculation of audit fees.

8. Should the Audit Excess Fee Bill not become law, the relevant provisions of the Public Audit Amendment Act, 2018 in which the principle of a direct charge is captured, will not commence, and those provisions will have to be repealed or amended by Parliament again.