

# AUDIT OUTCOMES AND THEIR ROLE IN CLEAN ADMINISTRATION IN MUNICIPALITIES WITHIN LIMPOPO PROVINCE, SOUTH AFRICA: A DETERRENCE THEORY APPROACH

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## ABSTRACT

In a period of three months subsequent to the end of every municipal financial year, the Auditor General of South Africa (AGSA) receives financial statements from municipalities within which to express various audit opinions which relate mainly to financial affairs. This paper is merely a legislative compliance exercise rather than one seeking to correct the status quo by attaching punitive measures to officials found to be responsible for non-conforming transactions. To sustain its argument, the paper uses the Deterrence Theory. The paper further argues that the use of punitive measures particularly in the recommendations by AGSA could serve to deter poor financial management and misuse of municipal funds. It could further assist in strengthening accountability and enhance municipal service delivery. The paper adopts a Content Analysis method to interrogate Audit Outcomes of Local Government: Limpopo Province to analyse the trends in relation to Audit Outcomes for the financial years ranging from 2011-12 to 2013-14.

**Keywords:** Auditor General of South Africa, Audit opinion, Auditing, Prevention, Deterrence Theory.

## 1. INTRODUCTION

In a period of three months subsequent to the end of every municipal financial year (1 July to 30 June the following year), the Auditor General of South Africa (AGSA) receives financial statements which municipalities are required to submit within which to express various audit opinions which relate mainly to financial affairs. This paper argues that the use of punitive measures utilising the Deterrence Theory as the theoretical framework particularly in the recommendations by AGSA could serve to deter poor financial management and misuse of municipal funds.

This could assist in strengthening accountability and enhance municipal service delivery and clean administration. The paper adopts a Content Analysis method to interrogate Audit Outcomes of Local Government: Limpopo Province to analyse the trends in relation to Audit Outcomes for the financial years ranging from 2011-12 to 2013-14. In doing so, this paper specifically focus on findings arising from the audit of financial statements, findings arising from the audit of supply chain management and findings arising from the audit of unauthorised, irregular, fruitless and wasteful expenditure. This is so because; these are the areas which have been over the years as indicated by the AGSA as areas of major concern at a local government level. The paper attempts to do this by firstly explaining the design and methodology used to execute the paper, the conceptualisation of auditing as an activity, the theoretical framework used to view and address the challenges, the legislative framework underpinning auditing, explaining various audit opinions, findings and finally the conclusion and recommendations.

## 2. DESIGN AND METHODOLOGY

A research design according to Mouton (2014:107) is a set of guidelines and instructions to be followed in addressing the research problem and enables the researcher to anticipate what the appropriate research decisions should be in order to maximise the validity of the results. In an attempt to interrogate audit outcomes and their role in clean administration this paper has adopted literature review and content analysis. Although closely related to hermeneutics, content analysis is a method used to analyse the content of documents (such as policy documents, annual reports and pieces of legislation) for any meanings, pictures, symbols, themes or messages that could be communicated (Wessels & Thani, 2014:167). The paper adopts a Content Analysis

method to interrogate Audit Outcomes of Local Government: Limpopo Province to analyse the trends in relation to Audit Outcomes for the financial years ranging from 2011-12 to 2014-15. The intended goal therefore is to identify inclinations in audit opinions and the frequency to establish the impact of audit outcomes to clean administration. This will assist in proving a linear path for financial governance which is aimed at producing unqualified audit outcomes for all municipalities in South Africa which in turn will enhance the delivery of services.

### **3. CONCEPTUALISING AUDITING AS AN ACTIVITY**

The term audit is derived from the Latin term '*audire*,' which means to hear (Online). The original objective of auditing is to detect and prevent errors and frauds. Auditing grew rapidly after the industrial revolution in the 18<sup>th</sup> century with the growth of the joint stock companies in which the ownership and management became separate. The objective of audit and auditing shifted and it was expected to ascertain whether the accounts were true and fair rather than detection of errors and frauds. In the South African context and in terms of section 1 of the Public Audit Act (25 of 2004), audit as an activity refers to the examination or investigation, in accordance with any applicable audit standards, which in this case is municipalities in Limpopo Province. Economic decisions in every society must be based upon the information available at the time the decision is made. If there is lack of coherence between a decision and what informs it, information used in the decision-making process will be unreliable (Inavona & Gibcus, 2003). In a municipal environment for instance, unreliable information can cause ineffective use of financial resources in particular and subsequently undesired outcomes in relation to service delivery. As local government has become more complex (Nkuna, 2011), there is an increased likelihood that untrustworthy information is provided to a municipality. It is because of this that auditing has become a mechanism in which techniques in terms of Generally Accepted Accounting Principles (GAAP) are used as a common way to obtain reliable information particularly by independent persons. The audited information is then used in the decision making process on the assumption that it is reasonably complete, accurate and unbiased. Conventionally, auditing is an examination of books of accounts and transaction of a concerned municipality, wherein the Auditor General of South Africa (AGSA) is to satisfy himself that the balance

sheet is properly drawn up, so as to give a true and fair view of the state of municipal affairs and that the financial statements gives true and fair view of the profit/loss for the financial period, according to the best of information and explanation given to him and as shown by the books; and if not, in what respect he is not satisfied (AGSA, 2012). This paper interrogates the role of audit outcomes and their impact on clean administration in the context of the South African local government using municipalities within the Limpopo Province as a unit of analysis. By so doing, the Deterrence Theory is adopted to justify for the positive punishment and deterrence for those municipal officials charged with and responsible for municipal financial affairs and thereby producing undesired audit outcomes.

### **4. THE THEORETICAL FRAMEWORK: DETERRENCE THEORY**

Deterrence is the control of behaviour that is affected because the potential offender does not consider the behaviour worth risking for the fear of its consequences (Elliot, nd). It involves the threat of punishment through some form of sanction. In the context of this paper, the mismanagement of municipal's financial and other resources is viewed as a behaviour that needs to be controlled through the imposing of sanctions. The paper argues that this has the potential of assisting in minimising and curbing unethical behaviour which results in undesired audit outcomes.

"Proponents of deterrence believe that people choose to obey or violate the law after calculating the gains and consequences of their actions. Overall, however, it is difficult to prove the effectiveness of deterrence since only those offenders not deterred come to the notice of law enforcement. Thus, we may never know why others do not offend". (Bosworth, 2005).

The Deterrence Theory is positive in nature and aims at preventing 'wrong' actions in society. In South African municipal context, the theory can be viewed and applied in a verge to ensure that mismanagement of financial resources in particular is minimised through imposing punishment to offenders. Executive management in municipalities ought to conduct their daily affairs with the conscious and knowledge that their undesired actions are punishable by law and other means. The theory is traced to the early works of philosophers such as Thomas Hobbes, Cesare Beccaria and Jeremy Bentham (online).

In Hobbes's thinking, people generally pursue material gain, reputation and safety. However, in doing so, public resources bestowed upon those running government machinery get manipulated and exploited. In terms of the Deterrence Theory, punishment for mismanagement, looting and corruption must be greater than the benefit that comes from committing such crime. Deterrence is the reason municipal officials must be punished for violating social contract and the public trust bestowed upon them. A piece of legislation such as the Local Government: Municipal Finance Management Act (56 of 2003), must be amended to criminalise and deter financial mismanagement resulting from deliberate non-compliance and disregarding the recommendations of the AGSA. The paper acknowledges that the legislative framework is insufficient to deal with financial mismanagement. Mathebula (2014) acknowledges that although punishment and deterrence alone are insufficient for promoting ethical conduct and clean administration particularly in public sector financial management, morality and *Ubuntu* equally play a critical role in curbing unethical conduct. It is in this view that there are various legislative frameworks that are promulgated to promote clean administration and financial management. However, they are not comprehensive enough to deter and criminalise financial mismanagement.

## **5. LEGISLATIVE FRAMEWORK: UNDERPINNING FINANCIAL MANAGEMENT AND AUDITING**

South Africa has promulgated various pieces of legislation that are aimed at ensuring that auditing and financial management in the public sector in general and municipalities in particular is performed in a way that minimises and curb the misuse of funds and critical resources aimed at the development of the general citizenry. Some of these pieces of legislation include the Constitution of the Republic of South Africa (1996), Local Government: Municipal Finance Management Act, (56 of 2003), and Public Audit Act, (25 of 2004). It must however be acknowledged that pieces of legislation on their own cannot be able to address corruption and financial mismanagement prevalent to municipalities. Hence Mathebula (2014) argues that Acts of parliament fail to inculcate appropriate public sector culture and morality for reducing and curbing financial mismanagement and corruption. This however does not underscore the importance of having these legislative frameworks in place.

### **5.1 Constitution of the Republic of South Africa, 1996**

Chapter 9 of the Constitution of the Republic of South Africa, 1996 establishes the Auditor-General of South Africa as one of the state establishments supporting constitutional democracy (AGSA online). The Constitution (1996) recognises the significance and pledges the independence of the AGSA, stating that the institution must be impartial and must exercise its supremacies and execute its functions without fear, favour or prejudice. The functions of the AGSA are pronounced in section 188 of the Constitution (1996) which mandates the AGSA to perform constitutional and other functions. Constitutional functions are those which the AGSA performs to comply with the broader mandate described therein. With all the powers vested on the AGSA, all government departments, municipalities, state organs and institutions are bound by law to comply with the requests of the AGSA to supply their financial statements for the purposes of audit.

### **5.2 Local Government: Municipal Finance Management Act, 2003 (56 of 2003)**

In terms of section 92 of the Act, the Auditor-General must audit and report on the accounts, financial statement and financial management of each municipal entity. The word 'must' as contained within the Act is a clear indication of the obligation without discretion that must be performed by the AGSA as a matter of bound legislative requirement. It is in this vein that section 95 of the same Act places responsibility upon the accounting officer (i.e. municipal manager) to keep full and proper records concerning the financial affairs of a municipality in an effective, efficient and economic manner. Furthermore, in terms of section 102 of the Act irregular or fruitless and wasteful expenditure must be detected and reported to the mayor so that appropriate steps can be taken. It is on this basis that the AGSA will act in accordance of those financial statements and supporting documentation to make a determination in the form of audit outcomes. Of course, the drafters of the Act had a good intention of ensuring that municipal funds are utilized for the purposes of improving the livelihood of the citizenry. However, despite these legislative prescripts, funds continue to be misused, hence this paper argues for the punitive measures that could have been incorporated in the Act to curb and minimize corruption particularly in municipalities.

### **5.3 Public Audit Act, 2004 (25 of 2004)**

The Public Audit Act, 2004 (25 of 2004) was promulgated to give effect to the powers of the AGSA as enshrined in section 188 of the Constitution of the Republic of South Africa, 1996. The Act provides for the AGSA to be the external auditor of all national and provincial state departments and municipalities, and any other institutions and accounting entities in terms of law. In carrying out the audit functions in terms of section 10 of the Act, the AGSA must submit annual reports to the National Assembly about; the standards to be applied to audits, the categories of services provided, and the institutions and accounting entities to which such services have been rendered. Section 14 (1) of the Act further indicates that financial statements submitted to the AGSA by an auditee subject to Local Government: Municipal Finance Management Act (56 of 2003), must be submitted within the period (i.e. three months subsequent to the end of every municipal financial year), be in a format, contain the information as required by legislation. For operational purposes in terms of section 1 of this Act, auditee refers to an institution or accounting entity that is or is to be audited and includes any group of such institutions or accounting entities whose financial statements are consolidated in terms of legislation. In the context of this paper, the term auditee will be used to refer to municipalities in the Limpopo Province audited by the AGSA. Section 19 (1) of the Act states that an auditee must; render all reasonable assistance to the AGSA to enable the auditor to complete the audit within any applicable timeframes. It is after the AGSA has performed an audit that a report on the audit must be prepared in terms of section 20 of the Act which will reflect on the opinion and statements. A determination is therefore made on this basis of an audit opinion being expressed by the AGSA.

## **6. AUDIT OPINIONS EXPRESSED BY THE AUDITOR GENERAL OF SOUTH AFRICA**

There are four common audit opinion that can be expressed by the Auditor-General.

### **6.1 Disclaimer of Opinion**

The Auditor General of South Africa (AGSA) shall disclaim an opinion in extremely rare circumstances. This is so because this opinion is only possible when the auditor is unable to obtain sufficient appropriate audit evidence on which to base an opinion. This could simply imply that the AGSA was unable to issue

an opinion either that the disclaimer as a result of lack of financial statements and other records. The question then is; who is to blame for lack of financial record? It is in cases such as this that this paper calls for extreme punishment and deterrence particularly to accounting officers of municipalities. Mechanisms that enhance the reliability of information and foster accountability, transparency and good governance, are the functions of the internal audit committee (Ngope & Ngulube, 2013:45) within the reporting municipality. One can therefore conclude that municipalities that receive disclaimer of opinion are falling short in relation to internal auditing mechanisms. It is therefore expected that municipalities who receive disclaimer of opinions strengthen their internal audit mechanisms. This according to the Act is the principal function of the municipal manager with the assistance of the chief financial officer.

### **6.2 Adverse Audit Opinion**

The AGSA expresses an adverse opinion when auditors have obtained sufficient audit evidence from the municipality concerned but concludes that the financial, accounting standards and transaction(s) are both material and inescapable to the financial statements. In this instance, the municipality has failed to confine its accounts, transactions and financial statements to specific elements. A practical example in this regard would be to purchase a billing machine without having obtained a minimum number of quotations as may be required by legislation. Should the AGSA find out while in the audit process, an adverse opinion shall be expressed. It is in instances like this that this paper advocates for deterrence and punishment in the event of municipalities deliberately ignoring legislative prescription for whatever reason.

### **6.3 Qualified Audit Opinion**

The AGSA expresses this opinion after having sufficient evidence, concludes that the municipality's financial records are material but not pervasive to financial statements in terms of the Generally Accepted Accounting Principles. In such an instance the AGSA is unable to obtain sufficient audit evidence in which to base the opinion. To this end, a question to which the reader can be a referee of is; whether this is due to incapacity on behalf of financial officers and accountants or rather a deliberate act of the unwillingness to disclose malicious transactions or records and allow the auditor to express an opinion?

This is comprehensively answered by Ngope and Ngulube (2013:45) who clearly point out that accountability in government requires a system of reporting and control in which record-keeping forms the base for such a system.

#### **6.4 Unqualified Audit Opinion**

Once the AGSA expresses an unqualified audit opinion it means that the municipality's financial records and statements have been presented fairly and appropriately in terms of the Generally Accepted Accounting Principles. This is a type of an audit opinion which South African municipalities should strive for as it translates to sound financial management and the financial statements are free from misstatements unlike a qualified audit opinion. The following section presents the AGSA findings of the municipalities within Limpopo Province.

### **7. THE STATE OF LOCAL GOVERNMENT IN LIMPOPO PROVINCE: FINDINGS**

As indicated earlier, the findings presented in this paper do not include all the audit findings as expressed by the AGSA. However, finding presented concern those arising from the audit of financial statements, supply chain management, and unauthorised, irregular, fruitless and wasteful expenditure. Furthermore, the findings are period focused.

#### **7.1 Audit of Financial Statements**

In the 2011/12 financial year, only two auditees submitted financial statements with no material misstatements (AGSA, 2012). This basically means that, majority of the auditees in Limpopo Province failed to produce credible and reliable financial statements. The continued reliance on the AGSA to identify misstatements in order to produce an unqualified audit opinion is deemed an unacceptable practice. Overall, 15 (52%) auditees failed to correct all the material misstatements identified during the audit process due to unavailability of information and documents to determine amounts as reflected in financial statements (AGSA, 2012). There are also a great number of repeat and new qualifications which of course is a cause for concern. This is so because as the AGSA noted; qualifications are increasing despite the appointment of consultants in the majority of the auditees with Limpopo Province. Shockingly these findings continue to show a similar trend of lack of improvement during the financial years under study. This, taking into account that there are

recommendations provided after each audit report, is worrying. A more drastic step of holding those responsible for managing municipal financial affairs is necessary.

#### **7.2 The Audit of Supply Chain Management**

The audit for supply chain management (SCM) includes procurement processes, contract management and the related controls in place (AGSA, 2013). To ensure a fair, equitable, transparent, competitive and cost-effective SCM system, the processes and controls need to comply with legislation and minimise the likelihood of fraud, corruption, favouritism and irregular practices. SCM audit was conducted only in 29 auditees for the 2011-12 financial year (AGSA, 2012). It is noteworthy that two municipalities (*Agang and Fetakgomo*) regressed from no findings on SCM to findings on SCM (*Ibid*). In total, 26 (90%) auditees showed direct correlation with irregular expenditure and non-compliance with legislative frameworks. No consequences for poor performance and non-compliance with SCM laws and regulations resulted in officials being negligent in adhering to legislation underpinning transparent procurement processes. The leadership failed to give attention to ensuring that municipalities and entities operated within the ambit of the law. There is no doubt that deviations from legislation is a direct result of poor control measures.

#### **7.3 The Audit of Unauthorised, Irregular, Fruitless and Wasteful Expenditure**

Section 32 of the Local Government: Municipal Finance Management Act (56 of 2003), requires accounting officers to take effective and appropriate steps to ensure that unauthorised, irregular, fruitless and wasteful expenditure is prevented. The Act makes it compulsory for auditors to disclose such expenditure in cases where it happens in the financial statement. Such expenditure must therefore be investigated. If the investigation determines that an official is liable for the expenses, disciplinary steps should be taken and the expenditure recovered.

In the 2011-12 financial year, a total of 28 (90%) auditees incurred one or more type of unauthorised, irregular, fruitless and wasteful expenditure (AGSA, 2012). Findings on compliance related to unauthorised, irregular, fruitless and wasteful expenditure remain the second highest non-compliance area in all auditees. The findings

regressed to 27 (87%) of the auditees from the 24 (77%) auditees in the 2011-12 financial year. The most common finding was irregular expenditure not prevented at 24 (77%) auditees, which is a regression from 16 (55%) in the previous year. A total of 22 (77%) auditees failed to conduct investigations and take action against officials who made or permitted unauthorised, irregular, fruitless and wasteful expenditure. During the 2012/13 financial year, all municipalities within the Limpopo Province accounted to R418 million worth of fruitless expenditure (AGSA, 2013) with little insignificant improvement of the 2011/12 financial year. Furthermore, R859.6 million was irregularly spent in the same period due to noncompliance of SCM regulations. Irregularities in SCM management range to wide issues such as failure comply with regular awarding of tenders, price fluctuations and total ignorance of the policy framework underpinning supply chain.

## 8. CONCLUSION AND RECOMMENDATIONS

This paper attempted to interrogate the state of financial affairs of municipalities within Limpopo Province. This was done through literature review and Content Analysis of Municipal Audit Reports of the AGSA. The paper was espoused within a notion that if recommendations contained in the Reports were implemented, the misuse of funds can be prevented. However, such is not the case and this paper views this picture very worrying as the municipal citizenry continue to live in abject poverty due to lack of services. It is therefore incumbent that strict implementation and political will be sought for with regard to the AGSA recommendations. This paper therefore calls for the criminalisation and imposing of harsh measures against transgressors if clean administration within municipalities is to be achieved. Such can be done within the notion of the Deterrence Theory as indicated in the paper.

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