

**AN EVALUATION OF FACTORS AFFECTING THE PROGRESSION  
TO CLEAN AUDIT OUTCOMES IN SOUTH AFRICAN  
MUNICIPALITIES**

By

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## DECLARATION

I declare that the thesis titled: *AN EVALUATION OF FACTORS AFFECTING THE PROGRESSION TO CLEAN AUDIT OUTCOMES IN SOUTH AFRICAN MUNICIPALITIES*, hereby submitted to the University of Limpopo, for the degree of Doctor of Public Administration has not previously been submitted by me for a degree at this or any other university; that it is my work in design and in execution, and that all material contained herein has been duly acknowledged.

.....

**SIGNATURE**

**(MR KN MOTUBATSE)**

.....

**DATE**

## **DEDICATION**

This study is dedicated to my late father Morewane Rooi Motubatse, my father-in-law Mashego Nkadimeng, mother-in-law Lefalane Nkadimeng, and grandmother Marungwane Sepadi. This thesis would have little meaning if not for all of you.

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“What, then, shall we say in response to this? If God is for us, who can be against us?” (*Romans 8:31*).

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## ABSTRACT

This research examines the effectiveness of the factors that have been introduced to bring about progress to clean audit outcomes in South African municipalities. This research has become increasingly important as the democratic dispensation in South Africa has witnessed a gradual weakening of public financial accountability. As a consequence of this ongoing decline, the National Government initiated the campaign “operation clean audit” as a means to achieve a new level of improved audit outcomes. The Auditor General of South Africa (AGSA) identified three key factors that would drive improved audit outcomes, namely leadership, financial management and governance. Given that “operation clean audit” had seemingly become an elusive dream by 2014, the researcher decided to examine the relative effectiveness of the causative variables identified by the AGSA as key to achieving improved audit outcomes. This research therefore was intended to make a contribution to the body of academic knowledge by pursuing the following objectives: to examine the effect of leadership on the achievement of clean audit outcomes in the South African public service; to analyse the effectiveness of financial management in the South African public service; to evaluate the effect of governance on the achievement of clean audit outcomes in the South African public service, and to propose a framework for understanding the factors that affect clean audit outcomes in the South African public service. To achieve the research objectives, the research applied a positivist paradigm and a quantitative approach. Data were collected from the AGSA’s consolidated municipal reports from the nine provinces of the Republic. Hence, the study was limited to the use of municipal audit reports, consolidated into single reports for all the municipalities in each of the provinces over a period of years. Thus, the study examines a total of nine consolidated reports for each of the five years between 2009/2010 – 2013/2014. Using the panel data approach, this produced a set of nine cross sectional units and 5 periods which thus produced 45 time series observations. Subsequently, a panel data multiple regression analysis was conducted to analyse the data. After correcting the model for heteroskedasticity, the results from the regression analysis revealed important relationships in only two dimensions. On the one hand, the three independent variables – leadership, financial management and governance – jointly

have a significant relationship with clean audit outcomes, with a P value  $P < 0.000$ , which is substantially below the 5% alpha level anticipated for this research.

The independent variables were each examined for their individual effects on clean audit results. Results show that only governance has a significant and direct effect on the achievement of a clean audit. Given that governance has a substantially stronger impact on the achievement of clean audits (far more than do the other variables), further analysis was conducted to determine the variables that influence the efficiency of governance. The results reveal that the effectiveness of the audit committee has an overriding influence on the ability of an entity to achieve clean audits. The findings thus appear to confirm the Auditor General's broad claim that leadership, financial management and governance are the key drivers to improved audit outcomes: but further analysis reveals that this happens only when the three variables are analysed as a single unit, to examine whether they significantly enhance clean audit outcomes. As single variables, only governance proved to affect clean audit outcomes significantly. The findings from the analysis thus corroborates the literature, thus achieving the first three research objectives.

Arising from this analysis, the researcher was able to propose a framework for understanding the factors that affect an entity's progression to clean audit. This constituted the achievement of research objective 4, and makes a contribution to the current body of knowledge on the topic. Thus, this research contributes to knowledge in that it develops a framework for understanding the factors that affect the achievement of a clean audit, and proposes two key approaches to further research and improve public sector auditing: a model to research the variables that affect audit committee effectiveness; and a practical approach that includes additional variables (drawn from the framework) during the public sector audit.

### **Key words**

Accountability, accounting, audit committee, audit quality, clean audit, financial management, governance, leadership, public administration, public policy, public sector, supreme audit institution.

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# CHAPTER 1

## INTRODUCTION

### 1.1 INTRODUCTION AND BACKGROUND

In recent years, the 'clean audit' opinion has received significant attention following the repeated failure of local governments in South Africa to achieve better audit outcomes (Cooperative Governance and Traditional Affairs (COGTA), 2009; National Treasury, 2014). The importance of achieving a 'clean audit' opinion has been confirmed by the National Treasury, the Ministry of Cooperative Governance and Traditional Affairs (COGTA) and the Office of the Auditor-General South Africa (AGSA) as a key indicator of the achievement of a clean administration (National Treasury, 2014; COGTA, 2009; AGSA, 2011/12). The "outbreak" of failures to achieve clean audit opinions has been identified as the result of various challenges faced by local governments, including poor leadership, weak financial management and weak governance (Mazibuko & Fourie, 2013; Association of Chartered Certified Accountants (ACCA), 2010; Deloitte, 2013a); and South African local governments are not unique in facing these challenges (COGTA, 2009; PricewaterhouseCoopers (PwC), 2010; Schoeman, 2012). The situation also exists, to greater or lesser degree, in provincial and national government departments and entities, and appears to be endemic in third world and developing countries. In a review of the factors affecting South African local government entities' progress towards achieving clean audit opinions, the challenges of inadequate leadership, financial management and governance have been at the centre of the discussion. According to Martin (2015:1-3), effective leadership can foster resilience in local government. However, it does seem that effective leadership has eluded many South African municipalities, and this has resulted in the placement of unskilled personnel as managers of public finances, with debilitating consequences (Smoke, 2015). Weak leadership, ineffective financial management and weak governance structures has undermined the efforts of South African municipalities to attain clean audit opinions. Adding salt to this wound, academic researchers have found that effective governance possesses the potential to foster accountability in public sector financial management (Abdellatif, 2003; Fasenfest, 2010; Jørgensen & Sørensen, 2012;

Bevir, 2010; Stoker, 1998; Grindle, 2004; Lewis, et al. 2015; Maserumule, 2011; Matshabaphala, 2014), and to achieve improved service delivery, which is desperately needed in the South African local governments (Begum, et al. 2014; Shah, 2006; Phago, 2012; Netserwa & Kgalane, 2014).

Achieving a clean audit opinion is one of the key elements used to assess audit quality and the soundness of underlying business processes (International Federation of Accountants (IFAC), 2014). Assisting their progress towards achieving the desired clean audit opinion, South African local governments depend largely on their own governance strategies, financial sustainability efforts and sustainable service delivery programmes (COGTA, 2009). These three focus areas were endorsed by the South African Cabinet as key to their comprehensive Local Government Turnaround Strategy (COGTA, 2009). Furthermore, it was intended that by 2014 all local governments should have achieved clean audit opinions. (Local government is viewed as an accountability vehicle responsible for putting national service delivery policies into action, as well as improving the welfare of the people it serves (Phago, 2012; Netswera & Kgalane, 2014). The desired demonstration of public sector accountability, can be achieved through effective leadership (Institute of Directors (IoD), 2009; Tsatsire, et al. 2010), efficient financial management (Eze & Harrison, 2013) and effective governance processes (Kroukamp, 2007), but this is still proving elusive in South Africa.

Local governments in South Africa have still not achieved widespread clean audit outcomes (Powell, et al. 2014) and this reflects a lack of clean governance, and a failure to produce financial statements that are credible (Geiger, et al. 2014). Again, it has been identified as weak leadership, poor financial management and weak governance in the local government sphere that has hampered effective service delivery (AGSA, 2012/13), and undermined the objective of the campaign for clean audits.

Thus, as leadership, financial management and governance are recognised as key business elements possessing the ability to influence the achievement of an improved audit quality (AGSA, 2013; Webb, 2015; Francis, 2004, Jelic, 2012; Otley & Pierce, 1995; Krohmer & Noël, 2010; KPMG, 2014b; Rahimi & Amini, 2015; Neri &



Russo, 2014; IFAC, 2014; Ziaee, 2014; Darabi, et al. 2012; Alrsha, 2015; Gajevszky, 2014; Fooladi & Farhadi, 2011; Adeyemi & Fagbemi, 2010; Khlif & Samaha, 2014), and as South African municipalities continue to fail to achieve clean audits, the need to research the present effectiveness of leadership, financial management and governance in South African municipalities was identified.

## **1.2 PROBLEM STATEMENT**

A number of researchers have highlighted the fact that audit challenges faced by local governments globally are directly related to the quality of leadership, financial management and governance (Siswana, 2007; Dalton, et al. 1998; Martins & Álvarez, 2007). These factors are pertinent to the achievement of clean audit opinions; in South Africa this has been the target for all local governments across the country, that by the end of the 2013/14 financial period all the municipalities must have achieved clean audit opinions (COGTA, 2009). However, the target has been a challenge for all, and unachievable in too many municipalities across the country. Weak leadership, poor financial management and the lack of effective governance have repeatedly been reported by the AGSA and others as key obstacles to the achievement of clean audit opinions since the target was set in 2009 (AGSA, 2013).

Related studies by Deloitte (2012), Van der Walt (2012), and Mazibuko and Fourie (2013) focus on South African strategies to improve audit opinions from “disclaimer”, through “adverse” and “qualified” to “clean audit” status. Elsewhere, research has been conducted to determine the importance of leadership on audit quality (Webb, 2015; Francis, 2004, Jelic, 2012; Otley & Pierce, 1995; Krohmer & Noël, 2010; KPMG, 2014b); the relationship between financial management and audit quality (Rahimi & Amini, 2015; Neri & Russo, 2014; IFAC, 2014; Ziaee, 2014; Darabi, et al. 2012; Alrsha, 2015); and the effect of governance on audit quality (Gajevszky, 2014; Fooladi & Farhadi, 2014; Adeyemi & Fagbemi, 2010; Khlif & Samaha, 2014). However, neither the South African nor the international researchers have specifically investigated the combined effect of these three independent variables (leadership, financial management and governance) on audit quality. This investigation has become important for several reasons, including the fact that, according to the AGSA (2013) there are three key drivers of improved audit quality:

leadership, financial management and governance. Furthermore, the widespread non-achievement of clean audits by the 2014 target requires an examination of how effective these drivers have really been in the journey to clean audits. To the best of this researcher's knowledge, no research has empirically investigated the extent to which these variables, either in combination or individually, affect the progress to 'clean audit' status in South Africa. Given that the journey to universal 'clean audit' status was not achieved by the target date of 2014, it becomes pertinent to examine how these variables have influenced the journey to 'clean audit' so far. This research thus addresses the apparent gap in the South African literature on the factors that influence audit quality, and in doing so, responds to the call by DeFond and Francis (2005) for appropriate empirical research in this regard.

### **1.2.1 Research questions**

Arising from the problem statement above, the general question upon which this research rests is this: how have leadership, financial management and governance influenced the journey to clean audits in South African municipalities. The specific questions directing this research are therefore:

- How does leadership affect clean audit outcomes?
- How does financial management affect clean audit outcomes?
- How does governance affect clean audit outcomes?
- What possible guidance framework can be developed to accelerate the achievement of clean audit outcomes in a developing economy such as South Africa?

### **1.2.2 Research objectives**

In line with the above research questions, the general objective of this research is to examine the effectiveness of leadership, financial management and governance in South African municipalities' journey to achieving clean audits. Hence, the specific objectives of this research are:

- to evaluate the effect of leadership on the achievement of clean audit outcomes;
- to analyse the effect of financial management on the achievement of clean audit outcomes;
- to evaluate the effect of governance on the achievement of clean audit outcomes; and
- to propose a guidance framework for achieving clean audit outcomes in a developing economy such as South Africa.

### **1.2.3 Research aim**

The aim of this study is to examine the factors affecting progress to achieving clean audits in South African local governments, and to use the results to develop a framework that would ultimately help accelerate the process. Whilst the AGSA's objective was to achieve clean audit outcomes in all municipalities *and* provincial departments by 2014, this examination of the effect of leadership, financial management and governance on the achievement of clean audits is limited to the efforts of municipalities only, as these are the entities that provide basic services at grass roots level. The research makes use of the Auditor General's consolidated municipal audit reports for each province, for the period 2009/10 – 2013/14. While the analysis of the data provides interesting insights, the ultimate goal of this research is to propose a practical guidance framework that will assist the AGSA and municipalities to understand (and thus enable better directed efforts to improve) the factors that affect progress to clean audits. In so doing, the researcher will also be adding to the body of academic knowledge on the subject.

### **1.3 DEFINITIONS OF TERMS**

**Service delivery:** refers to the provision of public activities, benefits or satisfactions, including both tangible public goods and intangible services (World Bank, 2011). In this study, the term refers to public service essentials, the key services being water, electricity, housing, health and sanitation, provided by the public sector to the general public, and to the providers' abilities to ensure that these essentials are provided within the prescribed time and that they meet customers' needs.

**Audit quality:** the term audit quality encompasses the key elements within the financial reporting chain (such as inputs, processes, outputs and key interactions) that create an environment which maximizes the likelihood that quality audits are consistently performed (IFAC, 2014). Audit quality is defined as the probability that an auditor will both discover and report an error in a client's accounting system (DeAngelo, 1981). Outputs collectively comprise one of the elements by which audit quality is evaluated, and include (internal) auditors' reports (to users, governance, management and regulators); reports of the audit committee; information provided by regulators on individual audits; transparency reports; annual reports, and the results of the audit firm's inspections (IFAC, 2014). Therefore, for the purpose of this study, the term 'audit quality' is used as a catch-all phrase signifying the element of audit outcome.

**Qualified audit opinion:** the auditor expresses a 'qualified' opinion when they have obtained sufficient appropriate audit evidence and conclude that misstatements, either individually or in the aggregate, are material to the financial statements, but not pervasive; or, when the auditor is unable to obtain sufficient appropriate audit evidence on which to base their opinion, but nevertheless conclude that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive (South African Institute of Chartered Accountants (SAICA), 2013/14).

**Adverse audit opinion:** "the auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements" (SAICA, 2013/14).

**Disclaimer of opinion:** "the auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive" (SAICA, 2013/14).

**Unqualified audit opinion (unmodified):** refers to the opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respect, in accordance with the applicable financial reporting framework (SAICA, 2013/14). According to AGSA (2011/12:4) a financially unqualified audit opinion means that the financial statements contain no material misstatements.

**Clean audit opinion:** means that the financial statements are free from material misstatements (i.e., a financially unqualified audit opinion), and that there are no material findings in the entity's reporting on performance objectives or non-compliance with legislation (AGSA, 2011/12a). In other words, a clean audit opinion means that the municipality has practiced sound financial management for the year in question; that their statements were deemed credible, and they complied with all statutory requirements. In other words, everything was accounted for and all monies were properly spent and managed (AGSA, 2009/10).

**Governance:** refers to the duties fulfilled by a person or organisation with responsibility for overseeing the strategic direction of the municipality, and the fulfilment of its accountability obligations (SAICA, 2013/14).

**Audited financial statements:** refers to the financial statements once audited by the auditor in accordance with the International Standard on Auditing, and from which the summary financial statements are derived (SAICA, 2013/14).

**Performance management:** is the process of defining clear objectives and targets for individuals and teams, the regular review of the actual achievements, and the eventual confirmation of rewards for target achievement (Akbar, et al. 2012).

**Local government:** is a form of public administration which, in a majority of contexts, exists as the lowest tier of administration within a given state. The term is used to distinguish this from offices at state level, which are referred to as the central government and/or national government. South Africa has a two-tiered local government system comprising smaller local municipalities (which are grouped into district municipalities), and substantially larger metropolitan municipalities (RSA, 1996).

## **1.4 STRUCTURE OF RESEARCH**

This thesis comprises nine chapters. Their outlines are as follows:

**CHAPTER 1: INTRODUCTION** – this chapter introduces and provides an initial background to the study. It is structured as follows:

**1.1 INTRODUCTION AND BACKGROUND:** This section presents a roadmap for the whole thesis.

**1.2 PROBLEM STATEMENT:** The problem highlighted by the primary literature in this study suggests that the challenges faced by local governments are directly related to issues of leadership, financial management and governance (Siswana, 2007; Dalton, et al. 1998; Martins & Álvarez, 2007). The following subsections arise from the problem statement and are briefly discussed next:

**1.2.1 Research question:** the general question upon which this research rests is this: how effective have leadership, financial management and governance been in influencing the journey to clean audit outcomes in South African municipalities?

**1.2.2 Research objective:** the general objective of this research is to examine the effectiveness of leadership, financial management and governance on the journey to achieving clean audits in South African municipalities.

**1.2.3 Research aim:** the aim of this study is to examine the factors affecting the journey to clean audits in South African local governments.

**1.3 DEFINITIONS OF TERMS:** provides brief definitions of the following terms: service delivery; audit quality; qualified audit opinion; adverse audit opinion; disclaimer of opinion; unqualified audit opinion (unmodified); clean audit opinion; governance; audited financial statements; performance management, and local government.

**1.4 STRUCTURE OF RESEARCH:** the thesis is structured into nine chapters, wherein Chapter 1 provides an introductory discussion of the topic; Chapter 2 sets

out the theoretical framework; Chapter 3 provides the conceptual background to auditing and audit outcomes; Chapter 4 comprises a review of the literature on leadership and audit outcomes; Chapter 5 presents a review of literature on financial management and audit outcomes; Chapter 6 presents a review of literature on governance and audit outcomes; Chapter 7 presents the research methodology; Chapter 8 presents the analysis of data, and interprets the findings, and lastly, Chapter 9 presents the conclusions and recommendations for further study and investigation.

**1.5 SIGNIFICANCE OF THE STUDY:** The study would be particularly beneficial to leaders, financial managers and governance structures in government as it should assist them to understand their roles and the changing needs of the society they serve.

**1.6 SUMMARY OF THE CHAPTER:** Chapter 1 concludes with a summary of the chapter.

**CHAPTER 2: THEORETICAL FRAMEWORK –** Chapter 2 presents the theoretical foundation for this research. There are two major theories underpinning this research: agency theory and stewardship theory. Chapter 2 is structured as follows:

**2.1 INTRODUCTION:** an overview of the Chapter.

**2.2 AGENCY THEORY:** Agency theory describes the important agent-principal relationships. In the context of local government, agents (councillors and municipal employees) have an obligation to fulfil the expectations of the local communities. According to Mitchell and Meacham (2011:151), agency theory could be used to understand a variety of organisational activities, including those in the public sector. This section applies agency theory, in the context of the public sector, to auditing, leadership, governance and financial management.

**2.2.1 Agency theory in local government – communities' relationships:** this section discusses the application of agency theory in the context of local government

**2.2.2 Agency theory in auditing:** This section discusses the application of agency theory in the context auditing. According to Leung, et al. (2009:7), agency theory is a useful economic theory of accountability particularly as it helps to explain the development of auditing.

**2.3 STEWARDSHIP THEORY:** Stewardship is viewed as an “obligation to provide services in an effective and efficient manner that meet the needs of the citizens [clients] of the South African public service institutions without exception” (Nzimakwe & Mpehle, 2012:280). This section applies stewardship theory in the context of public sector auditing, leadership, governance and financial management.

**2.4 SUMMARY OF THE CHAPTER:** Chapter 2 concludes with a summary of the chapter’s key issues.

**CHAPTER 3: AUDITING AND AUDIT OUTCOME –** Chapter 3 presents the conceptual and historic background to this study, and serves as a guide to understanding the relevance of the literature consulted in researching this thesis. The chapter is structured as follows:

**3.1 INTRODUCTION:** presents the highlights of Chapter 3

**3.2 DEVELOPMENT OF AUDITING:** Auditing is an essential tool of governance, and traces its formalisation at least as far back as the Middle Ages (+/-900 – 1200 AD). This section, however, focuses on the practice of auditing during the industrial revolution (+/-1800 to 1900 AD), the period in history when large scale mass production techniques came to dominate national and regional economies (Leung, et al. 2009; Kołosowska & Voss, 2014).

**3.3 EMERGENCE OF PUBLIC SECTOR AUDITING:** Public sector auditing has emerged as a type of governance employed to promote accountability in the management of public sector organisations (Humphrey, et al. 1993). Public sector auditing then is effectively a practice intended to strengthen governance and increase the public's confidence in public sector organisations and processes.



**3.3.1 Role of auditing in the public sector:** Public sector auditors play an important role in achieving effective public sector governance (Institute of Internal Auditors (IIA), 2012). In the South African public sector, the AGSA conducts audit in three categories - mandatory audits, discretionary audits and special audits (AGSA, 2011/12).

**3.4 AUDIT OUTCOME:** this section discusses audit outcomes in the context of audit quality. An audit outcome is an element (or function) of audit quality (IFAC, 2014) and is a communication from the auditor – usually in the form of a written opinion (Fahami, et al. 2016). It is the last product or service in the accounting process rendered by the auditor. This section then discusses audit outcomes in the context of the formally defined audit opinions: disclaimer of audit opinion, adverse audit opinion, qualified audit opinion, unqualified audit opinion and clean audit opinion.

**3.4.1 Clean audit opinion awareness:** this subsection discusses the South African government's motivation for using the concept, and examines the elements that support a the goal of clean audit opinions.

**3.4.2 Drivers of improved audit outcomes:** Audit quality is a function of the quality of internal controls (AGSA, 2011/12). The Auditor-General South Africa has identified the three key drivers of internal control as leadership, financial management and governance. The improvement of an audit outcome therefore depends on improvements in these key drivers of internal control.

**3.5 SUMMARY OF THE CHAPTER:** Chapter 3 concludes with a summary of the chapter's key points.

**CHAPTER 4: MUNICIPAL LEADERSHIP AND AUDIT OUTCOME –** Chapter 4 reviews the existing literature on the relationship between leadership and audit outcomes, and is structured as follows:

**4.1 INTRODUCTION:** the introduction presents a brief overview of Chapter 4.

**4.2 LEADERSHIP AND AUDIT OUTCOMES:** This section discusses the concept of leadership and its relationship to audit outcomes under the following sub-headings:

**4.2.1 Concept of leadership:** Leadership is the process of influencing followers in order to achieve (unified) organisational objectives, through guiding changes in their behaviour (Lussier & Achua, 2007:6).

**4.2.2 Link between leadership and audit outcomes:** The declining quality of audit outcomes has become a concern as South African local governments routinely fail to receive clean audit opinions. This subsection discusses the relationship between leadership and audit outcomes as a contributing factor.

**4.3 LEADERSHIP ACCOUNTABILITY:** The Auditor General, in its annual assessments, asserts that it is a lack of accountability in leadership that adversely affects the audit quality (AGSA, 2011/12). Therefore, accountability requires effective and appropriate leadership (Thompson, 2013; Said, et al. 2015), which is also a crucial step in efforts to enhance public confidence in local government.

**4.4 LEADERSHIP IN THE CONTEXT OF LOCAL GOVERNMENT:** Leadership in the local government is about formal authority and influence (Siegel, 2010; Giroux & McLelland, 2003; PWC, 2010; Zhang, 2014). Leaders motivate others and the quality of the leadership determines the degree to which the organisation's goals are achieved (Weil, et al. 2013:1). This section also describes the leadership function in municipal councils, and examines the forces that influence municipal managers, as follows:

**4.4.1 Municipal council:** According to Siegel (2010:141), local government leadership consists of the municipal council and elected officials.

**4.4.2 Municipal manager:** Municipal managers are effectively serving two masters – political and administrative. Their roles are influenced by their party's political dynamics, and they are also expected to take responsibility for national and provincial policy implementation (Giroux & McLelland, 2003; Zhang, 2014).

**4.5 STRATEGIC LEADERSHIP:** strategic leadership is described in the context of local government. According to Verwey, et al. (2012:102), strategic leadership requires a leaders to take a long-term view of the process, and to exercise strong direction on the implementation of the constituent short term goals.

**4.6 ETHICAL LEADERSHIP:** this section describes ethical leadership in the context of local government. According to Kacmar, et al. (2013), the quality of leaders' ethics is based on the norms and values they uphold. These values require leaders to act in a trustworthy manner even when they are not being observed (Yuki, et al. 2013:41).

**4.7 SUMMARY OF THE CHAPTER:** Chapter 4 concludes with a summary of the chapter's key points.

**CHAPTER 5: MUNICIPAL FINANCIAL MANAGEMENT AND AUDIT OUTCOME –**  
Chapter 5 reviews the literature on the relationship between financial management and audit outcomes, and is structured as follows:

**5.1 INTRODUCTION:** presents a brief overview of Chapter 5.

**5.2 FINANCIAL MANAGEMENT AND AUDIT OUTCOME:** This section discusses the concepts of financial management and audit outcomes as follows:

**5.2.1 Concept of financial management:** Financial management is a concept built on the convergence of two business concepts – finance and management. It is defined as the management of the finances of an organisation in order to achieve the financial objectives of the organisation (Brigham & Houston, 2012), and it affects all components in the organisation (Ciuhureanu, et al. 2009).

**5.2.2 Link between financial management and audit outcome:** Audit outcomes reflect the effectiveness of financial management (IFAC, 2014; Rahimi & Amini, 2015; Neri & Russo, 2014; Svanberg & Ohman, 2013). However, the quality of the audit also plays an important role in determining the reliance users of the financial statements may place in them (Alrsha, 2015). Therefore, if the auditors are highly

competent and insightful, their accuracy will assure users of the financials that the financials are accurate. If the auditors are incompetent/inexperienced, their opinions carry less authority and thus down-grade the value users can assign to their opinions and thus the AFSs.

**5.2.2.1 Financial reporting quality:** essentially, what brings the audit and financial management together is the financial statements. So, the audit evaluates the internal controls and the assertions made by the financial management team to the auditor about the information presented in the financial statements.

**5.2.2.2 Internal financial control quality:** Financial management cannot be isolated from internal control. The effectiveness of internal financial controls and the accuracy of audit reports are the main determinants of audit quality (Goh, et al. 2013). This section discusses the quality of internal financial controls in the context of financial management.

**5.3 FINANCIAL MANAGEMENT IN THE LOCAL GOVERNMENT:** this subsection describes key features and functions of financial management in the local government sphere, including the following:

**5.3.1 Asset and liability management:** asset and liability management is defined as the process by which an institution manages its balance sheet in order to accommodate fluctuating interest rates and changing liquidity scenarios (Sheela & Bastray, 2015:34).

**5.3.2 Revenue management:** in order to collect revenues, the municipalities need to ensure that billing systems are accurate, that the residents are being sent relevant accounts, and that outstanding revenues owed to municipalities are being collected in an approved manner and timeframe (National Treasury, 2015).

**5.3.3 Expenditure management:** expenditure management involves ensuring that the allocated funds are used to achieve the agreed priorities, and that this information is made available to government to enable them to plan and monitor the performance of their (national) programmes (Morrell & Kopanyi, 2014:216). Hence,

in South Africa, National Treasury plays an important role in managing all government expenditures.

**5.3.4 Budgeting:** this is a key policy document from which all government revenues and expenditure are managed (OECD, 2002).

**5.3.4.1 Budget preparation:** budget preparation is a technical process (CIMA, 2008). It is nevertheless still influenced by the politics of local government (Amujiri, 2013:57).

**5.3.5 Cash management:** Morrell and Kopanyi (2014:251-252) state that the objectives of cash management are to bring funds into the local government's control as quickly as possible and to pay the funds out as efficiently as possible, while making effective use of the funds until they are needed for operating expenses.

**5.3.6 Debt management:** a prudent debt management strategy and associated policies is necessary and should be a top priority.

**5.3.7 Performance management:** according to Roos (2009) performance management is a process that is intended to eliminate any undesirable actions or effects, and that it should only encourage desirable actions.

**5.4 SUMMARY OF THE CHAPTER:** Chapter 5 concludes with a summary of the chapter's key points.

**CHAPTER 6: MUNICIPAL GOVERNANCE AND AUDIT OUTCOME –** Chapter 6 reviews the literature on the relationship between governance and audit outcomes, and is structured as follows:

**6.1 INTRODUCTION:** presents a brief overview of Chapter 6.

**6.2 GOVERNANCE AND AUDIT OUTCOME:** this section discusses the relationship between governance and audit outcomes as follows:

**6.2.1 Concept of governance:** governance is a concept described as the exercise of political, economic and administrative authority over the management of a country's affairs (United Nations Development Programme (UNDP), 1997; International Monetary Fund (IMF), 2007).

**6.2.2 Link between governance and audit outcome:** There is a direct link between the effectiveness of governance role-players and audit outcomes or audit quality. Such a link is contingent upon the presence of an efficient internal audit function, risk management function and audit committee. Thus:

**6.2.2.1 Internal audit and governance:** Effectively, internal audit's role compliments that of governance. Internal audit adds value to the structures of governance through its role in the control environment, through risk assessment and in reviewing governance processes (Christopher, 2015).

**6.2.2.2 Risk management and governance:** Risk management is the practice of identifying and analysing the risks associated with the business and, where appropriate, taking adequate steps to manage these risks (IOD, 2009:73). As a result, it enables governance structures to ensure that controls are in place to manage those risks (Subramaniam, et al. 2009; Spira & Page, 2003).

**6.2.2.3 Audit committee and governance:** The audit committee is responsible for the quality of financial reporting and for the audit processes of both internal and external auditors (Brennan & Kirwan, 2015; Inaam & Khamoussi, 2016; Zaman & Sarens, 2013; IFAC, 2014). A strong audit committee enhances audit quality (Gotti, et al. 2012). The audit committee's role is also discussed in this section in the context of its independence, financial literacy, experiences, commitment and regularity of meetings.

**6.3 SUMMARY OF THE CHAPTER:** Chapter 6 concludes with a summary of the chapter's key points.

**CHAPTER 7: RESEARCH METHODOLOGY** – Chapter 7 presents the research methodology followed in this study. The chapter is structured as follows:

**7.1 INTRODUCTION:** presents a brief overview of Chapter 7.

**7.2 RESEARCH METHOD AND DESIGN:** This section presents the plan or blueprint of how the study was conducted, and how the objectives were achieved (Babbie & Mouton, 2010:74). This study follows a positivist paradigm, since it is associated with a quantitative research method. Therefore, the researcher uses a causal research design as it assists in the understanding of why the world works the way it does through the process of identifying causal links between variables in the form of an X and Y in research (Brewer & Kubn, 2010).

**7.2.1 Research area:** The research area for this study is all the municipalities in the nine provinces of the Republic of South Africa.

**7.3 POPULATION AND SAMPLE:** The *population* for this study is limited to the sum of all the municipalities in the nine provinces of Republic of South Africa. The studied population is addressed in the AGSA's consolidated reports on the local government audit outcomes for the period from 2009/10 to 2013/14. The *Sampling Technique* and *Research Sample* are described as non-probability sampling, which is appropriate when the study attempts to answer a particular set of research questions (Berzofsky, et al. 2013; Latham, 2007; Fox, 2010; Babbie, 2013). The justification for use of purposive sampling is also discussed.

**7.4 DATA COLLECTION PROCEDURES:** this subsection describes the data collection procedures and details the methodology used for data collection: in this research data is documentary or secondary archival data. Leedy and Ormrod (2013) explains that data collection begins after the research problem has been identified and the research design finalised. The secondary data to be used is available to the public on the AGSA's website. It includes the audit outcomes reports from the 2009/10 to 2013/14 financial years. Research data used in this study include the key drivers of internal control (including leadership scores, financial management scores, governance scores and the scores on clean audit outcomes) from the nine (9) provinces of South Africa.

**7.5 DATA ANALYSIS PROCEDURES:** According to Li, et al. (2011:387) panel data analysis has received renewed attention over the last decades because of its applicability to a diversity of disciplines, including economics and finance. It has also become an important analysis tool in the field of public administration and other fields of business research (Sarafidis & Wansbeek, 2012). The data analysis procedures used are described as follows:

**7.5.1 Multiple regressions:** regression analysis was used as a research instrument to analyse data generated from the secondary data and to determine the correlation or relationship between clean audit outcomes and the independent variables of leadership, financial management and governance. The model  $Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \varepsilon$  is also discussed.

**7.6 RESEARCH VALIDITY:** validity is concerned with the extent to which the research data is able to generate accurate information which addresses the research questions.

**7.7 RESEARCH RELIABILITY:** According to Babbie (2013:188) reliability is concerned with quality of the measurement method, and suggests that the same data should be collected each time in the repeated observations of the same phenomenon. Adams, et al. (2014:245) report that the most important element of reliability lies in the nature of the variables.

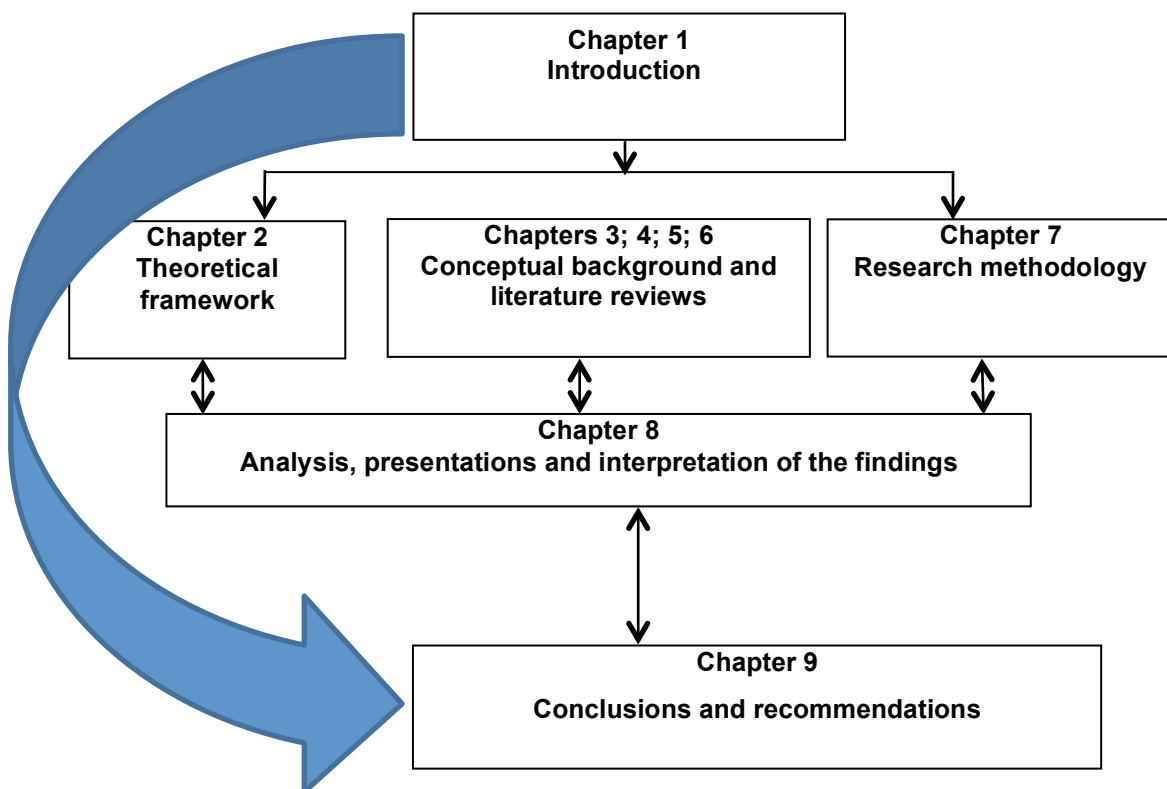
**7.8 ETHICAL CONSIDERATIONS:** The University of Limpopo, like any other academic institution of higher learning enrolling students for postgraduate research, is very particular about ethics in that research. Ethics in research helps to ensure that no research processes infringe on human rights, nor do they cause any kind of harm by revealing information of a confidential nature about the individuals involved (Wisker, 2008). Because this study involved no contact with human participants, performance of the conventional ethical procedures was not possible.

**7.9 SUMMARY OF THE CHAPTER:** Chapter 7 concludes with a summary of the chapter's key points.



**CHAPTER 8: DATA ANALYSIS AND FINDINGS** – this chapter discusses the detailed data analysis, and interprets and presents the findings arising from the evaluation of factors affecting the achievement of clean audits in South African municipalities. The findings are synthesised from the panel data analysis using a regression model. There was a clear intention to discover a link between clean audit outcomes and each of the predetermined key drivers of audit outcomes, specifically leadership, financial management and governance.

**CHAPTER 9: CONCLUSIONS AND RECOMMENDATIONS** – Chapter 9 presents the conclusions drawn from this research, proposes a guidance framework for the achievement of clean audit outcomes, and presents recommendations for further study arising from it. The contribution made by this study to the body of knowledge on the topic is also discussed. The potential limitations of the study are identified and final concluding remarks are presented.



**Figure 1.1: Structure of the research**

## 1.5 SIGNIFICANCE OF THE STUDY

This study has the potential to benefit leaders, financial managers and governance structures in government, helping them to understand their roles and the changing needs of the society they serve. The study could also benefit management across all public sector entities, and not only local government, encouraging them to rethink their strategies and priorities in service delivery. It would also benefit the wider auditing profession and auditing practitioners in other sectors, as the distinctions between public and private sectors are becoming harder to define.

The practical relevance of this research to public administration therefore, is that it has revealed the need to extend the scope of the Auditor General's key audit focus areas to include governance's three key components. In doing so, the annual reports provided to the legislatures will enable them to develop more accurate and pertinent public service policies, and to improve monitoring to enhance effective and efficient delivery of public services to the citizens. This research therefore is of practical significance to public administration, both as a public sector profession and as an academic discipline, as it paves the way to deepen the relevance of the AGSA's audit efforts and to enhance the usefulness of its outcomes. Thus, this research, in finding that governance is *the* key policy implementer capable of improving public administration, has posed a challenge to the AGSA to give its components – internal audit, risk management and the audit committee – far more attention and support. Academically, the findings might necessitate a review of the current public administration curriculum, or at least prove the importance of integrating practical case studies in risk management and internal auditing (in addition to the current theory base), to strengthen the governance skill sets of future public administration graduates who will soon be taking up management positions in government departments and public service entities.

Lastly, the significance of this study can be extended to academic researchers and the National School of Government in that its insights could be useful in directing capacity building and developing interventions to address the training needs of managers already employed in government. It could also open new doors to

multidisciplinary research in the field of public administration and accounting sciences.

## **1.6 SUMMARY OF THE CHAPTER**

This chapter introduced this thesis and provided the necessary background to it. Arising from the identification of the broad thesis topic, the problem statement, research question, aim and objectives were also formulated. This chapter also presented the structure of the thesis. In the next chapter the theoretical framework of the study is discussed.

## **CHAPTER 2**

### **THEORETICAL FRAMEWORK**

#### **2.1 INTRODUCTION**

This chapter presents the theoretical framework of this study. The main theoretical support is derived from agency theory and stewardship theory. Agency theory discusses the relationship between the principals and the agents from the point of view that because both parties are motivated to act in their own best interests, the potential for conflict is increased. Stewardship theory describes the roles and accountability parameters of local government leadership (managers) and their governance functions – essentially how they employ their principals' assets most effectively. Stewardship theory is based on the assumption that managers, when left to do their jobs, will act in the best interests of their principals, making most effective use of the assets under management. The chapter concludes with a summary of the key issues discussed.

#### **2.2 AGENCY THEORY**

Agency theory was first conceptualised to understand the relationship between the principal and his/her agent (Zu & Kaynak, 2012; Hannafey & Vitulano, 2013). Hence, the theoretical framework, when applied to public sector entities, splits when trying to distinguish between agents and stewards in the local government sphere. For example, if the local government managers behave as agents, then they are expected to manage the government's resources, making use of national budget allocations (for housing, health, education, etc.) to improve the lives of the municipality's citizens through effective service delivery. Thus, agency theory is concerned with the principal–agent problem, which occurs when one person or entity (the "agent") is able to make decisions on behalf of, or that impact on, another person or entity - the "principal". As is increasingly clear from the escalating levels of protest in the country, some local governments are failing to use their basic service budgetary allocations either in full or appropriately. Thus, at financial year end the unutilised funds that should have been used to provide basic services are often

required to be returned to the National Revenue Fund and are then effectively lost to the local community (National Treasury, 2015). The relationship is made more complex because sometimes the agent is motivated to act in his own best interests rather than in those of the principal. In addition, there is frequently confusion as to who is “the principal” in the relationship: provincial and national governments, or tax- and rate-payers and local residents. It is for this reason that the agency theory therefore assumes that the managers have goals that are in conflict with those of their principals, and/or that managers (agents) may pursue their own goals even to the detriment of their principals. In addition, principals have difficulty in obtaining sufficient accurate information to be able to assess some of their agents’ (managers’) behaviour (Jensen & Meckling, 1976). For example, municipalities (their management structures and procedures) are supposed to address the problems that have typically existed between distant agents and principals. Thus, the local governments are the established organs of the state tasked with “last mile” service delivery, including water supply and quality issues, building houses to reduce backlogs, and installation and maintenance of sanitation services to the communities. In most cases, municipalities are part of an intergovernmental collaboration or network of government departments attempting to improve the living conditions of the nation’s citizens.

Of course, from time to time, the media reports that some poor communities in the country lack water, functioning sanitation services (particularly in informal settlements), and formal housing. In addition, existing infrastructure and facilities show the effects of poor maintenance, and this state of affairs has been encouraged by principals not holding their agents fully accountable (Stevens, 2013). The agents – politicians (whether democratically elected and/or “deployed” is not material) – are expected to take much more responsibility for the implementation of promises made during elections, and delivering on the expectations they have created about service delivery issues. Thus, all these expectations come in the wake of the agents’ promises made during election time – that “all the problems will be addressed” once the new government is in power. This conveniently ignores the fact that communities have been experiencing recurring non-delivery on promises made in the run-up to every election since 1994. To repeat, the role of the “agents” in the local governments is to address the needs of the communities that elect them (the

councillors), or to implement policy set out by their principals (national, provincial and municipal government structures), and to provide sustainable services. Various strategies have been advanced to strengthen the principal/agent relationship; however, it does appear that avarice and the undermining of the rule of law by many public sector agents (whether maliciously or because of ignorance) is counter to the principals' interests.

The agent-principal relationship is a useful analytic tool in political science and economics, but may also apply to other areas (Eisenhardt, 1989). Thus, the problem arises that the two parties have different interests and asymmetric information (the agent having more information and sometimes withholding some of it from the principal), such that the principal cannot directly ensure that the agent is always acting in the principal's best interests. This becomes particularly apparent when activities that are useful to the principal are costly to the agent, and where elements of what the agent does are costly for the principal to observe (Jensen & Meckling, 1976; Eisenhardt, 1989). Indeed, principals are increasingly concerned about the possibility of being exploited by their agents. Such suspicions are fuelled in particular by poor service delivery in and by local governments. Thus far, literature evidence suggests that the relationship between principals and agents in the South African local governments arena is weak and is evidenced by the declining level of basic service delivery. The weakness of this relationship is due to a number of issues including the fact that political considerations are frequently given precedence over the rule of law, and that personal reactions to inequalities in society sometimes turn violent.

Agency theory describes the importance of the agent-principal relationship. In the municipal service provision arena, the agents (councillors and employees) have an obligation to fulfil the expectations of their local communities. According to Mitchell and Meacheam (2011:151), agency theory could be used to understand a variety of organisational activities. In terms of agency theory, the principals delegate their power to the agents (Segal & Lehrer, 2012; Mitchell & Meacheam, 2011) who can then act on behalf of their principals (Zu & Kaynak, 2012; Hannafey & Vitulano, 2013; Mahaney & Lederer, 2011; Lopes, 2013; Basau & Lederer, 2011).

Much has been written about the dynamics of the principal-and-agent relationship as a means to explain agency theory (Zu & Kaynak, 2012; Hannafey & Vitulano, 2013; Mahaney & Lederer, 2011; Lopes, 2012; Basau & Lederer, 2011). Much of the literature discusses how the principal-agent relationship may be used to manage the delivery of services required to reduce problems faced by “customers” in the immediate vicinity of the agent. Agency theory has its origins in economic theory (Eisenhardt, 1989), and was proposed as a means to evaluate relationships between principals and their agents. Kivistö (2007:3) acknowledges its origin, but argues that agency theory is not only understandable in terms of the discipline of economics; it has applicability in various disciplines including accounting, marketing, political sciences, public administration and management. Agency theory was first conceptualised in an effort to understand the relationship between principals and their agents (Droege & Spiller, 2009; Segal & Lehrer, 2012; Mitchell & Meacham, 2011), a type of relationship that can be traced back at least to the third millennium BCE in the Near East. Thus, relatively recently Jensen and Meckling (1976) defined agency as

*“...a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent.”*

Caers, et al. (2006) argue that when agents are not fully controlled, there is the likelihood that the principals’ aims will not be achieved. Hence, agency theory proposes that the survival of any organisation depends not only on the relationship between the principals and their agents, but also on the assumptions that all needed information is being made available (Droege & Spiller, 2009). Such assumptions, according to Shapiro (2005), try to answer the questions as to how agency theory can be used across disciplines, and were found to be useful by social scientists when developing strategies to enhance principal-agent relationships. If the principal-

agent relationships are sound (shared objectives, complete and accurate reciprocal communications), the communities they serve stay informed about the nature and delivery of services due to them (Mitchell & Meacheam, 2011; Hilvert & Swindell, 2013). In this best case situation the agents championing the relationship become the local faces of good governance and effective service delivery (Brown, et al. 2009). In many respects the agents take the brunt of residents' dissatisfaction with the extent and pace of service delivery, but, because of ineffective communication with their principals (both provincial and national government departments, and voters and ratepayers), they are caught between the proverbial rock and hard place.

According to Mitchell and Meacheam (2011:151), agency theory can be used to understand various organisational activities. However, once appointed as agents, people are frequently tempted to become opportunistic and to place their personal interests ahead of those of their principals (Segal & Lehrer, 2012). Within the context of this study, agency theory is used to examine how the service delivery needs of the communities are being prioritised by local governments. Since agency theory is based on the concept that principals delegate their power to the agents, (Segal & Lehrer, 2012; Mitchell & Meacheam, 2011) it is equally valid that the principals can reclaim their delegated authority and act on their own behalf. In its simplest statement, this theory or business philosophy holds that agents are not going to exploit or compromise their principals' interests (Miller & Sardais, 2011; Zu & Kaynak, 2012; Hannafey & Vitulano, 2013; Mahaney & Lederer, 2011; Lopes, 2012; Basau & Lederer, 2011). Its validity, however, is continuously challenged in South Africa.

Within the parameters of agency theory, local governments can respond most effectively to address the community's expectations: in such municipalities public trust can be earned and increased through accurate and honest formal reporting. Certainly, the evaluation of factors affecting municipalities' progression to the achievement of clean audits could as well be used as a measurement tool to monitor the activities and effectiveness of local governments (Cohen & Leventis, 2013a). Within the context of public trust, Koma (2010) affirms that audit in the municipalities should be seen as a key element in ongoing efforts to increase the confidence of the



communities in their community's government leadership (Cohen & Leventis, 2013a).

Agency theory was developed to investigate an incomplete, asymmetric information- and risk-sharing relationship (Kivistö, 2007:3). Of course, the manifestation of the concept "agency theory" had been discussed extensively by various authors such as Jansen and Meckling (1976) and Eisenhardt (1989). Kivistö (2007:16) believes that in agency theory, the principals and the agents are considered to be self-interested actors. The most important aspect of agency theory however, is how responsibilities in the relationship are shared (Hannafey & Vitulano, 2013; Yoo & Rhee, 2013). In essence, in the context of South African municipalities, the agent is employed (and often unilaterally deployed) by the principals; hence they are accountable to the principals (Mitchell & Meacham, 2011; Zu & Kaynak, 2012). Agency theory is a pragmatic theory in which the agents and principals are expected to put their relationship into action (Arce, 2007). Accordingly, Mahaney and Lederer (2011) view agency theory as the study of information systems that bring better results. Therefore, it is imperative, within this context, that the challenges of financial and non-financial information preparation and publication faced by the South African local governments are addressed (Koma, 2010).

Given the systematic and operational aspects of the principal-agent relationship in the local government, Gailmard (2012) maintains that public accountability also requires explanations of who is accountable to whom. Agency theory is dependent on the premise that the principals are in control of the organisation and that they have delegated their responsibility to the agent (Namazi, 2013). This may indicate that by applying the agency theory paradigm, following Zu and Kaynak (2012), and Lopes (2013), and the agency theory explanation models of Mahaney and Lederer (2011), the principal-agent self-activating principle of Arce (2007), and the overall understanding of the principal and agency theory provided by Mitchell and Meacham (2011), among others, the systems and operations of local governments can be improved. Therefore, understanding the details of agency theory suggests that effective ways to improve the service delivery outcomes and to better the principal and agent relationships are both possible.

### 2.2.1 Agency theory in local government – communities' relationships

Agency theory has been called for in terms of section 238 of the Constitution, which requires that

*“an executive organ of state in any sphere of government may delegate any power or function that is to be exercised or performed in terms of legislation to any other executive organ of state, provided the delegation is consistent with the legislation in terms of which the power is exercised or the function is performed; or exercise any power or perform any function for any other executive organ of state on an agency or delegation basis”* (RSA, 1996).

According to Kivistö (2007:21) the problem with agency theory is that it is relatively easy for agents to send their principals false information. This is one of the major challenges faced by South African local governments, brought about by the weakness of local leadership and governance structures (AGSA, 2011). The AGSA points out that in general, the councillors and mayors do not demonstrate a sufficient understanding of their oversight functions, and neither is their reporting always credible or reliable. The local government system is effectively a principal-and-agent relationship. In terms section 152 of that Constitutional mandate (or delegation of authority) the objectives of local government are as follows:

- “a) to provide democratic and accountable government for local communities;*
- b) to ensure the provision of services to the communities in a sustainable manner;*
- c) to promote social and economic development;*
- d) to promote a safe and healthy environment; and*
- e) to encourage the involvement of communities and community organisations in the matters of local government”* (RSA, 1996).

According to Kivistö (2007:48), “public sector organisations, including local governments, receive public criticism”. In South Africa, local government and the communities they serve have gone through a period of transition, and should, over the past twenty years, have started to demonstrate a rudimentary understanding of

democracy. However, the issues and challenges around service delivery still remain largely unresolved (Koma, 2010). More accurately, these challenges have been characterised by a deterioration of service delivery, and increasingly visible and “robust” service delivery protests on the part of the communities (principals), registering their dissatisfaction with the ongoing maladministration by the councillors and employees (agents).

Arising from the service delivery challenges, the absence of accountability is seen to be at the centre of local government service delivery problems. Protest and unrest are increasingly being resorted to as the councillors remain unresponsive to normal communication channels, and ignore the matters that need their attention (World Bank, 2011). Accountability is an element of administration that holds the individuals or leaders who makes decisions and take actions on specific issues accountable for their actions (IOD, 2009). In other words, the growing service delivery challenges and visible protests across increasing numbers of South African municipalities are as results of a complex web of situations where promises made by the agents are still unfulfilled, and local governments employ doubtful governance practices and condone maladministration. Given the potential for self-interest to override the principals’ good intentions in the principal-agent relationships, there is increasing doubt about the agents’ ability to use local government resources efficiently, resulting in a lack of trust and confidence in the effectiveness of the local governments’ governance processes.

According to Hannafey and Vitulamo (2013), agency theory focuses on the understanding of relationships, that is, those that are necessary to maintaining a sound level of trust (Mitchell & Meacheam, 2011; Brown, et al. 2009; Droege & Spiller, 2009; Shapiro, 2005). Agency theory, with a particular view of how it applies in the local government arena, is illustrated in Figure 2.1 below.

The use of agency theory in this study is equally beneficial to municipal managers, employees, municipal councillors and the community at large. It highlights the importance of the information communicated by both parties.



**Figure 2.1: Agency theory in the local government (Source: Author own illustration)**

The study focuses attention on the evaluation of the factors affecting the journey to clean audit in the local government arena, and as the audit outcome is a significant communication tool, the importance of the principal-agent relationship as a driver of this communication, is key to this study.

Agency theory, when used to explain that local governments exist to deliver services to the communities, highlights the points that the principal-agent relationship should also be built on trust: that the agent will deliver as expected, and where challenges are experienced, principals will receive pertinent information promptly, enabling them to take strategic and effective decisions. Despite the fact that the local government agents are widely distrusted, demonstrate poor leadership, and have failed to apply good governance and transparency to their administrations, the principles of agency theory still remain valid and can help re-establish an effective, simple and straightforward relationship (Zu & Kaynak, 2012; Hannafey & Vitulano, 2013; Mahaney & Lederer, 2011; Lopes, 2012; Basau & Lederer, 2011).

### **2.2.2 Agency theory in auditing**

According to Leung, et al. (2009:7), agency theory is a useful economic theory of accountability, and it helps to explain the development of auditing. The auditor's role is to determine whether the reports prepared by the managers are in conformance with applicable legislation and accounting frameworks (IFAC, 2014). Agency theory was found to have a role in understanding auditing (Colbert & Jahera, 2011) as it attempts to explain how managers are expected to serve as agents for their principals (Gray & Manson, 2005). Auditing plays such an important role in this principal-agent relationship (Eilifsen, et al. 2006). In applying agency theory to auditing Leung, et al. (2009) maintain that auditing exists to monitor the activities of management and to attest to management's performance for the benefit of those charged with the responsibility of governance (Colbert & Jahera, 2011). Eilifsen, et al. (2006) also attest that auditing is needed to balance the relationship between owners and managers in view of the frequent asymmetry in the information flow between the two parties. Therefore, the positive aspects of agency theory seem to have connected to the broader role of auditing because auditing is able to play an independent role in monitoring relationships between managers and auditors; the audit report itself provides a competent, independent, objective overview of the principal-agent relationship, and is also a protector of the public's interest (Leung, et al. 2009).

Agency theory simply means that one party has delegated its responsibility to another party. Thus, agency theory can explain relationships between preparers of financial statements (managers and agents) and the independent evaluators (auditors – also agents), and the relationship between both with the principal. In Figure 2.2 an illustrative overview of the principal-agent relationship in auditing is suggested.

To understand how agency theory relates to auditing, it is helpful to first understand how agency theory addresses the results of information asymmetry between the principal and the agent, particularly as audit serves to increase confidence and reinforce trust in financial statements (Leung, et al. 2009:7).



**Figure 2.2: An overview of principal-agent relationship in auditing (Source: Principal-Agent relationship for auditing. Adapted from Eilifsen, et al. 2006)**

Leung, et al. (2009:7) highlight the role of auditing in the application of agency theory, drawing attention to the fact that the organisation lack the skills (or authority) to audit their own finances, so they appoint auditors to audit and identify agency problems (hence, auditors are the agents of the agents in this instance). Regulation affects the demand for and the role of audits – hence regulators, in acting to protect the interests of the principals, are themselves agents in the relationship; audit reports are matters of public interests – auditors are expected to carry out the audit of financial statements in an accountable manner to ensure that stakeholders (another set of principals) may have confidence that the organisation is accountable to them; and the role of auditing is increasing the extent and effectiveness of governance – and governance is concerned with the relationships and the role of other parties in governance. Therefore, consistent with the role of auditing in agency theory just described, Gray and Manson (2005) summarise that, by invoking agency theory in describing auditing’s various relationships, the appointment of professional external

auditors is preferred, as this is the most cost effective appointment of an agent to monitor the actions of the other agents.

### **2.3 STEWARDSHIP THEORY**

Stewardship theory is all about being in control of something that has been entrusted to one's care, but does not belong to the entrusted person (Podrug, 2011; Waters, 2013). Hence, politicians and government administrators are alike entrusted with the care of the nation's resources placed under their control during their tenure of office. Thus, the entrusted responsibilities can be removed by the communities, if the stewards are not accountable and responsible in their actions. For example, while most municipalities are reported to have been faced with corruption because of greedy stewards who have forgotten their roles (Corruption Watch, 2013), it is unfortunate that removal of such stewards has been left, increasingly, to the indiscriminating and violent actions of the previously ignored (local resident) principals. Thus, good stewardship is best demonstrated through responsibility in the management of public resources.

According to Corruption Watch (2013), there have been too many reports of maladministration, mismanagement of public funds and abuse of resources by the stewards at the local government level that have been apparently condoned. Corruption Watch's 2013 statistics show that 22% of reports received from the public implicate municipalities, traffic police, education institutions, housing subsidies and allocations, and the South African Police Services in poor service delivery and bribery. Corruption can creep into the running of municipalities and threaten the delivery of services if the stewards fail to protect the principals' assets, and neglect their responsibilities to use the assets wisely while under their care.

Stewardship theory is concerned with the management of resources by responsible people on behalf of the owners. Stewardship theory has a long history, and in the 19<sup>th</sup> century stewardship was extensively used in the context of running the affairs of the churches as they were not funded by the government (Wilson, 2010). Modern stewardship theory has its roots in governance (Podrug, 2011; Waters, 2013; Lindqvist & Mijovski, 2012; Kluvers & Tippett, 2011; Miller & Sardais, 2011; Robb,

2012). It is concerned that the behaviour of managers should be aligned with the interests of the principals (Lindqvist & Mijovski, 2012; Pastoriza & Ariño, 2008). A great deal of this study examines the topics of leadership, financial management and governance, requiring that the effect of stewardship theory on these activities also be considered as part of these aspects of the research.

In order to understand the thinking behind the seemingly radical concept of accountability, it is important to appreciate that the role of stewards in every public service institution is to deliver the service envisaged by their principals. Stewardship is a useful concept in management philosophies (Robb, 2012; Karns, 2011), and is applicable to a wide range of fields (Waters, 2013). The term stewardship means that a person is effectively entrusted with the responsibility of owning others' resources (Kluvers & Tippett, 2011; Miller & Sardais, 2011; Robb, 2012; Podrug, 2011; Lindqvist & Mijovski, 2012; Pastoriza & Ariño, 2008). Within the context of this study, the philosophy of stewardship requires that those entrusted with governance responsibilities and functions strive to be effective in the public service institutions employing them. In the local government perspective, the stewardship concept is invoked to remind all municipal officers about the service delivery responsibilities that is due to their principals, the public at large.

According to Podrug (2011:407), the fundamental postulate of stewardship theory is that managers always act in such a way as to maximize the interests of an organisation and to ensure an ethical quality of leadership. Stewardship theory examines the relationships where the local government managers are motivated by the work they provide to their communities (Waters, 2013). Therefore, the importance of the stewardship theory lies in its recognition of the "obligation to provide services in an effective and efficient manner that meet the needs of the citizens [the principals and beneficiaries] of the South African public service institutions without exception" (Nzimakwe & Mpehle, 2012:280).

Given the relationships that could influence the process of service delivery in the public service, the stewardship construct should be seen as embracing accountable leadership that builds a public's trust in that institution. However, as Alban-Metcalf and Alimo-Metcalf (2013) argue, the stewardship paradigm in the public service



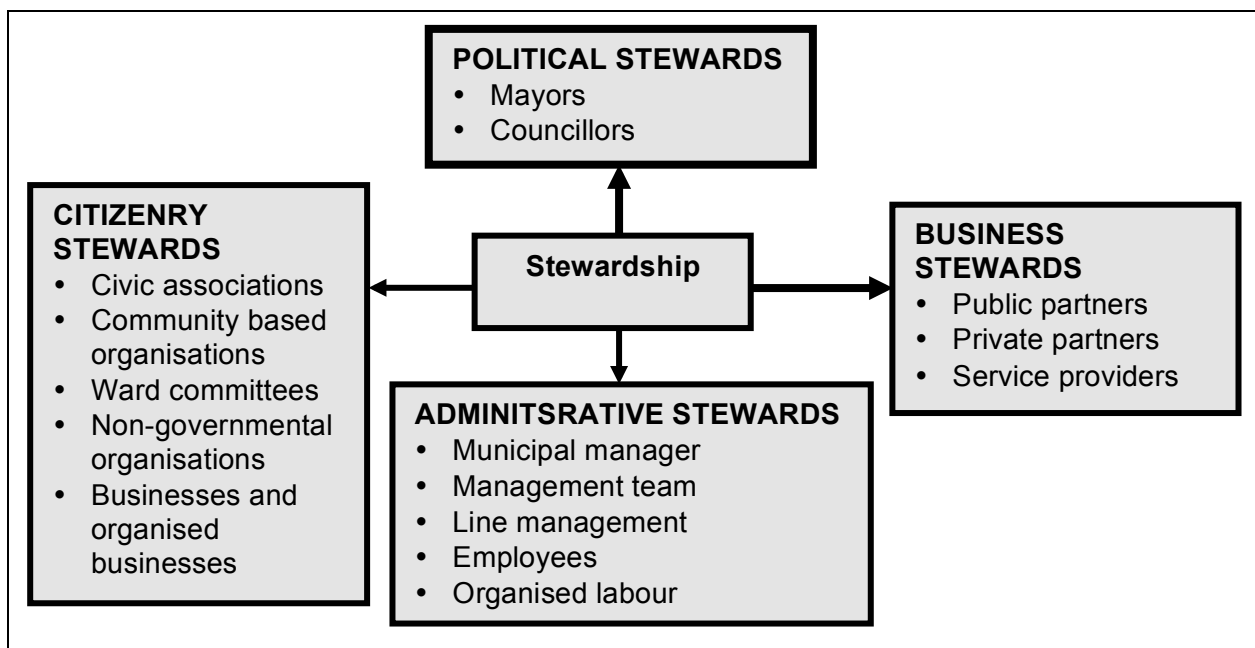
should provide the public with something more than a channel through which to interact with their governments. With this in mind, Ngwakwe (2012:322) affirms that being a good steward to the community means that there must be a “culture of mutual accountability among the government, public officials, service providers and the citizens”. Within the context of this study stewardship theory will be used to frame the literature review of the financial and non-financial aspects of accountability.

Stewardship can be equated with accountability. Accountability is defined as the process by which a person or group of people can be held to account (or responsible) for their conduct (Glynn & Murphy, 1996:127). In the South African local government context, the concept of accountability is derived from the Constitution (RSA, 1996). Within the context of the provisions of the Constitution, the MFMA was introduced (with its clear philosophy of financial accountability), to improve financial management systems in local government (RSA, 2003). The philosophy of the MFMA as defined in Section 165(1), requires that each municipality and each municipal entity has an internal audit function (IAF) (RSA, 2003). Section 165(2)(b)(i)-(vii) requires that the municipalities’ and municipal entities’ IAFs must advise the appropriate accounting officers (AO) and report to the entities’ audit committees (AC) on the implementation of the internal audit plan and matters relating to internal auditing, internal controls, accounting procedures and practices, risk management, performance management, compliance with the MFMA, the annual Division of Revenue Act instructions, and any other applicable legislation (RSA, 2003). But, as Van der Nest, et al. (2008:547) point out, financial accountability is not the only form of accountability in the public service institutions. However, for the purposes of this study, the philosophy of accountability will be discussed from the financial management perspective. As Khalo (2013) posits, financial accountability is becoming increasingly important in public service institutions, and one means of effecting accountability is through auditing.

Shah (2006:22) identifies the basic principles of local governance and accountability as comprising three elements. Thus,

- *responsive governance* is the principle that governments aim to do the right things (i.e., to deliver services consistent with citizen preferences);
- *responsible governance* is the principal that the government should do it right (i.e., manage its fiscal resources with prudent care). It includes the ideal that local government should earn the trust of residents by working better and costing less and by managing fiscal and social risks to the community. Government should also strive to improve the quality and quantity of and access to public services, by benchmarking its performance against the best performing (local) governments;
- *accountable governance*: a local government should be accountable to its electorate. It should adhere to appropriate safeguards to ensure that it serves the public interests with integrity. Such accountability should enable the community to be able to recall public officials for non-performance.

With this in mind, stewardship can be used to assist public sector managers to discover the service delivery strategies that will effectively yield positive results (Ngwakwe, 2012:323). The responsibilities and relationships pertaining to stewardship in the South African local government context are illustrated in Figure 2.3.



**Figure 2.3: Stewardship relationships in local government (Source: Researcher's own illustration)**

From the above it should be apparent that the concept of stewardship is the equivalent of accountability. An ideal embodied in stewardship is that elected councillors, citizens, administrative officials and public-private partnerships hold each other accountable for the effective and efficient running of the local government. The major elements of each stewardship role are presented in Figure 2.3 above. In the discussions to follow, the researcher will attempt to contextualise the philosophical ideas of each position, and match them with their practical implementation. Despite the fact that stewardship has become an important concept for identifying those whose responsibility it is to protect the interests and the resources of the local government, many proponents of stewardship theory (Podrug, 2011; Waters, 2013; Lindqvist & Mijovski, 2012; Kluyers & Tippet, 2011; Miller & Sardais, 2011; Robb, 2012) proceed rather from the viewpoint that stewardship is about efficient and effective use of resources to benefit businesses and communities (both local and regional), and thus the country as a whole. Therefore, it is essential to note that the *key stewards* are the local government administrators.

Mazibuko and Fourie (2013) recognise that mayors, municipal managers, councillors and officials have the greatest responsibility to demonstrate good stewardship and accountability. Accordingly, the term stewardship has been viewed as a descriptor of the relationships between governments, industries and the public at large (Saner & Wilson, 2003). Thus, stewardship is also built upon the principles of social responsibility, where the stewards are encouraged to strengthen their relationships with communities through consultations. According to the King Code of Governance Principles and the King Report on Governance in Southern Africa (King III) (IOD, 2009), in terms of stewardship in local government, an organisation is expected to act with intellectual honesty, exercise accountability in decision-making, be committed and courageous, and also demonstrates the knowledge and skills required for governing local government entities effectively. Depending on the role of individual stewards, Saner and Wilson (2003) argue that the stewardship concept is an essential driver of the consultation processes, the system of governance oversight practices, and also in setting out voluntary initiatives. Notwithstanding the fact that stewardship recognises that there may be a significant degree of separation between ownership and control, in local government ownership and control often lie in the hands of the same people. It is thus important for the council to empower

executive management and its council committees appropriately, so as to ensure a balanced view of the municipality's strategic direction.

## **2.4 SUMMARY OF THE CHAPTER**

This chapter provided a theoretical framework and foundation for the study. Applying the theories of agency and stewardship also provided a useful pair of perspectives from which to investigate the factors affecting progress towards the achievement of 'clean audits' in South African local governments, and they explain how the study fits into existing theories of public entity management. Agency theory holds that the agent and the principal cannot be separated. Their relationship depends on the assumptions that the principal is in control and that the agents derive their authority from their principals. In the South African local government context the agents (municipal mayors and managers) are given their power/authority by their principals (electorate and/or provincial and national government) in order to manage the local government on their behalf. There is an assumption that the agent's self-interest might distort the principals' intentions with respect to managing the principal's business. Thus, while the agent owes the principals a product – service delivery in the local government scenario – there is an acceptance that this might not happen exactly as required by the principals. On the other hand, stewardship theory holds that governance, as an important element of accountability, is an intrinsic component of the principal/steward relationship. The chapter's discussions of these theoretical concepts were limited to the local government context. The next chapter discusses the concepts of auditing and audit outcomes.

## **CHAPTER 3**

### **AUDITING AND AUDIT OUTCOMES**

#### **3.1 INTRODUCTION**

This chapter discusses the conceptual backgrounds to three topics: the development of auditing; the emergence of public sector auditing, and audit outcomes. It presents a blueprint to understanding the relevance of these three concepts or processes by examining recently published and pertinent literature. The chapter ends with a brief summary of the key issues discussed.

#### **3.2 DEVELOPMENT OF AUDITING**

Auditing provides authority to governance and management control reporting systems (Griffin & Wright, 2015). This arises from the auditing function, having examined the final product of the accounting systems, then being able, on the basis of the credible evidence they have assembled, to provide an opinion or audit outcome (Kumar & Sharma, 2015). Auditing is an essential tool of governance, and its formal origins can be traced at least to the Middle Ages. The emergence of recognisably modern auditing practices can be traced to the European industrial revolution (roughly 1800 to 1900 AD) during which period large scale industrial production techniques took over manufacturing (Leung, et al. 2009; Kołosowska & Voss, 2014). Accountancy and auditing, according to the literature and archaeological evidence, were already in evidence in Greece as early as 500 BC (Eilifsen, et al. 2006), and even earlier in the ancient Near Eastern countries of Mesopotamia. Of course, both accounting and auditing took on additional responsibilities during the industrial revolution, when companies needed to raise capital from parties other than the original owners of the businesses, to finance their expansions. The word “audit” comes from the Latin word “*auditere*”, which means to hear, and as Kołosowska and Voss (2014) explain, the word includes the actions of listening, interrogating and examining. Describing how auditing has continued to enhance the accounting process, Gupta (2005:1) observes that:

*“auditing in its simplest form originated from almost the development of organised systems of accounting. As it became necessary to entrust one man with the property of another, the need for a check on the fidelity of the former arose. Hence, Mesopotamian relics of commercial transactions pertaining to the period 3600-3200 BC reveal tiny marks, dots, ticks and circles at the side of figures indicating that those figures had been checked. The ancient Egyptians got their fiscal receipts recorded separately by two officials while another official conducted their audit. The Greeks appointed checking clerks to scrutinise the accounts of public officials at the expiry of their terms of office, whereas the Romans who designed an effective system of financial administration, distinguished between the person authorising expenditure and the person responsible for actual receipts and payments.” Gupta (2005:1)*

Thus, the practice of auditing has been at the centre of every cycle of business activity for millennia. Today, auditing is a prominent component of the accounting profession, and is conducted in terms of internationally recognised standards. It is a well-recognised career discipline that owes its high profile and respect to its status as a profession. Philosophers such as Mautz and Sharaf (1961), postulate that financial data are verifiable; thus, in order for an audit to have value, no conflict of interest should exist between the auditors and the management of the enterprise under audit; other information submitted for verification should be free from collusive and other irregularities; systems of internal control should be in place to eliminate the probability of irregularities, and there should be a consistent application of generally accepted accounting principles in order for there to be a fair presentation of the financial position of the entity and the results of its operations. In the absence of clear evidence to the contrary, it should then be safe to assume that what has held true in the past for the organisation, will hold true in the future. When examining financial data for the purpose of expressing an independent opinion thereon, the auditors act exclusively in the capacity of auditor – the agents of the principals (shareholders/citizens); the professional status of the independent auditor imposes reciprocal professional obligations.

The value of the work of the auditor has been recognised by many scholars in the field of accounting and auditing, including Cadotte (2015:187), who commends their

work as a “legacy for contemporary contemplation in research, education, and professional practice”. The philosophy of auditing continues to attract academic attention (Mautz & Sharaf, 1961), ensuring that audit practice remains pertinent to the businesses it serves (Lee & Ali, 2008).

The development of the auditing profession, measured by its practitioners joining together to form national professional regulatory and representative bodies, occurred as the industrial revolution embedded itself as the dominant force in the world’s economies. It is perhaps worth noting that the trend appears to have been initiated in Anglophone countries: Scotland started the process, with the United Kingdom taking up the challenge some time later. This corresponds to the relative strengths and global reaches of the national economies at the time (Boynton & Johnson, 2006; Hay, et al. 2014; Meuwissen *in* Hay, et al. 2014). Table 3.1 presents the profession’s professionalisation timeline:

**Table 3.1: Historical development of auditing profession**

<b>Country</b>	<b>Old name: Professional Body</b>	<b>New name: Professional Body</b>	<b>Year established</b>
Scotland	Society of Accountants in Edinburgh	Institute of Chartered Accountants of Scotland	1854
United Kingdom	Incorporated Society of Liverpool Accountants	Institute of Chartered Accountants in England and Wales	1870
Australia	Incorporated Institute of Accountants	CPA of Australia	1886
United States	American Association of Public Accountants	American Institute of Certified Public Accountants	1887
New Zealand	Institute of Accountants of New Zealand	New Zealand Institute of Chartered Accountants	1894
South Africa	Institute of Accountants and Auditors	South African Institute of Chartered Accountants	1894
Netherlands	Nederlandsch Instituut van Accountants	Nederlandse Beroepsassociatie van Accountants	1895

Country	Old name: Professional Body	New name: Professional Body	Year established
Germany	Verband Deutscher Bucherrevisoren	Institut der Wirtschaftsprüfer	1896
Sweden	Svenska Revisoramfundet	Föreningen auktoriserade revirorer-2006	1899
Canada	Dominion Association of Chartered Accountants	Canadian Institute of Chartered Accountants	1902

**Source: Origin of the auditing profession (Meuwissen in Hay, et al. 2014)**

The auditing of South African public sector organisations (including State Owned Entities (SOEs)) is compulsory. It is a requirement in terms of the Companies Act 71 (RSA, 2008), Auditing Profession Act 26 (RSA, 2005) and the Public Audit Act 25 (RSA, 2004). In addition, the South African government has put measures in place to regulate the auditing within government institutions, most notably the Public Audit Act 25 (RSA, 2004). According to Hay, et al. (2014), auditing has recently undergone significant changes in response not only to changing business models, but also to the sometimes spectacular failures of major businesses as a result of fraud and corruption. Until recently, auditing has been closely associated with the accounting process and preparation of financial statements. However, the risks associated with this relationship began to take centre stage in the 1970s, and by the early 2000s there were strong moves globally to limit the provision of advisory services to audit firms' own audit clients (Hay, et al. 2014).

In the South African context, public sector organisations are audited by the Auditor-General, which has a Constitutional mandate to do so, and to report publicly on the accounts, financial statements, financial management and performance of the public sector organisations. The office of the Auditor-General was established over hundred years ago in 1911, in an effort to support the growing professionalism of the audit profession and to increase public confidence in the state's accounts (AGSA, 2011). The Auditor-General remains the only body of independent external auditors empowered by the Constitution to audit government departments and entities, and to report on any irregularities in the use of state resources.



### **3.3 EMERGENCE OF PUBLIC SECTOR AUDITING**

The emergence of public sector auditing as a set of processes and verification approaches distinct from those in use in private sector auditing, can be traced to the establishment of the Australian National Audit Office in 1979 (Guthrie & Parker, 1999). This institution was viewed as a vehicle to enhance the efficiency of government systems, and with the ability to influence agendas and activities at individual, organizational, institutional, socio-political and socioeconomic levels in the Australian public sector (Guthrie & Parker, 1999). According to Humphrey, et al. (1993), public sector auditing, as a governance type, emerged in the United Kingdom as a means to promote accountable management in public sector organizations. The military structures mimicked by the British Government in the nineteenth century have been shown to have significantly influenced the emergence of the public sector auditing and accounting functions in Britain (Funnell, 1997). The need for enhanced accountability had been at the centre of the establishment of a public sector auditing capacity as controls over spending levels were proving inadequate in all government departments (Funnell, 1997). Public sector auditing is thus tasked with strengthening governance's effectiveness and increasing the public's confidence in the public sector.

#### **3.3.1 Role of auditing in the public sector**

Public sector auditors play an important role in achieving effective public sector governance (IIA, 2012). The AGSA is a member of the International Organisation of Supreme Audit Institutions (INTOSAI), which oversees the setting of global audit standards for all external audit communities in public sector organisations. INTOSAI provides the local Supreme Audit Institution (SAI), commonly recognised as the Auditor-General South Africa (AGSA), a framework within which public sector audit organisations focus on accountability and transparency in the use of public funds. The AGSA is thus uniquely placed to contribute to building and sustaining stronger and more effective accountability mechanisms for the government and its citizens. The AGSA is a member of INTOSAI, which is an autonomous global organisation of government external audit institutions, and has special consultative status with the Economic and Social Council (ECOSOC) of the United Nations (AGSA, 2011). South

Africa's Auditor-General (as the government's external auditors) has been recognised for the role it is playing in promoting good governance processes in the country's public sector. Its approach to auditing has been seen as conforming to global best practices, and continues to promote accountability in efforts to meet the public's expectations (Leung, et al. 2009).

In South Africa, the AGSA, as the Supreme Audit Institution, reports on their clients' application of accounting standards, compliance with other mandatory professional reporting requirements, and fulfilment of their statutory and other regulatory obligations (IRBA, 2012). The currently applicable accounting standards are the Generally Recognised Accounting Standards (GRAP) (National Treasury, 2005), which replaced the International Financial Reporting Standards (IFRS) (IFAC, 2014) as the prescribed standard for South African municipalities in 2009. South African public sector audits thus now assess municipal financial statements' compliance against the Standards for GRAP. The Standards for GRAP, when used in accounting for public sector transactions, enables South African public sector entities to compete on the global investment, loan and grant market because the information is now available to users in a globally preferred and recognised format for accountability and decision-making (National Treasury, 2005).

Fakie (1999) pointed out that the AGSA's role as auditor of the public sector in South Africa can only be effective if its independence is maintained. In many respects, the AGSA provides a good demonstration of effective governance processes in the public sector, as it ensures that its own efforts are conducted transparently and with full accountability for the financial and performance information presented to Parliament and the public at large each year (IRBA, 2012:30). According to Auditor General (2011/12), audit in the South African public sector is used to "assess the stewards of public funds, the implementation of government policies and compliance with key legislation in an objective manner". The scope of the AGSA's mandate is prescribed in the Public Audit Act 25 of 2004 (RSA, 2004). The Act requires the AGSA to "audit and report on the accounts, financial statements and financial management of all national and provincial state departments and administrations; all constitutional institutions; the administration of Parliament and of each provincial legislature; all municipalities; all municipal entities;

and any other institution or accounting entity required by other national or by provincial legislation to be audited by the AGSA” (RSA, 2004).

Given the development of auditing as reviewed in section 3.2, the term “audit” is described in terms of section 1 of the Auditing Profession Act as “the examination of, in accordance with prescribed or applicable auditing standards, financial statements with the objective of expressing an opinion as to their fairness or compliance with an identified financial reporting framework and any applicable statutory requirements; or financial and other information prepared in accordance with suitable criteria with the objective of expressing an opinion on the financial and other information” (RSA, 2005). Thus, as Soltani (2007:7) observes:

*“the need for emergence of auditing as with any other discipline is associated with the willingness of the interested parties (citizens, accounting officers, executive authorities and so on) to form a solid basis for making financial decisions. Each of these parties is considered as an economic actor seeking to maximise its wealth and in doing so, they want to know all the possible ways to achieve this goal. To acquire the necessary knowledge about these options requires a thorough understanding of the economic variables and of the relationship between them. This can only be done through the use of a theoretical framework, which provides sufficient explanation and reasoning of the variables, their association with each other and the environment in which the economic action is taking place.”*

As with the performance of an audit of any organisation, the AGSA’s audits increase the confidence of the general public in the audited institutions that the stewards are being held accountable for their use of public resources. The auditing of government and public sector entities has a positive impact on the levels of trust a society has in its public sector; it also “focuses the minds of the custodians of public resources on how well they use those resources” (AGSA, 2011). The public sector auditors assess the quality of stewardship of public funds, the implementation of government policies and compliance with key legislation in an objective manner. The scope of the annual audit performed for each auditee is prescribed in the Public Audit Act (RSA, 2004). Hence, auditing in the local government arena provides a unified view of how

municipalities are fulfilling their public accountability responsibilities (Nyman, et al. 2005:136). From the AGSA's point of view, they are accountable for providing assurance that the financial statements are free from material misstatements that could negatively affect the users of these financial statements; for reporting on the usefulness and reliability of the information in the annual performance reports; for reporting on the discovery of any material non-compliance with key legislation; and for identifying any deficiencies in key internal controls that should then be addressed in order to achieve a clean audit in the following financial year (AGSA, 2011/12).

Auditing is one of the cornerstones of good public sector governance (IOD, 2009; IIA, 2012). The Supreme Audit Institutions play a guardianship role over public resources (Mamidu, et al. 2015) and are also important promoters of governance to ensure each operational entity demonstrates full accountability. In South Africa the AGSA fills this role, and its duties and independence are set out in and guaranteed by the Constitution (RSA, 1996). Through its audits the AGSA ensures transparency and accountability in all government institutions including local governments' service delivery efforts. That South Africa is a democratic state and manages its affairs within the principles and requirements of its Constitution (RSA, 1996) is shown by the South African Constitution's repeated emphasis of the establishment of independent institutions such as the Auditor-General (RSA, 1996, section 181(e)). The AGSA thus performs the audits of local government entities and is accountable to the National Assembly for the accuracy and completeness of its reports on the audited information. As a result, the Parliament and the provincial legislatures are dependent on the AGSA's evaluation of the financial statements, and assessments of service delivery performances and whether the local government resources are being used effectively. To be specific, the AGSA's role in auditing and reporting on government institutions' accounts, financial statements and financial management, including all municipalities, is an essential component of efforts to ensure good governance (RSA, 1996). South Africa appears to be enjoying its democracy by giving institutions such as the Auditor-General a Constitutionally defined and protected status to enforce accountability in government.

In local governments, as in any other public sector organisation in South Africa, the role of the AGSA is to audit their financial and other statutory reports and outputs,

and thus to increase public confidence in their management of the municipality (AGSA, 2012/13). The AGSA's authority to audit local government entities is derived from its own competencies and abilities, and in its Constitutionally defined mandate to serve the public within the prescribed legal frameworks, and by applying ethical principles and professional standards at all times. Section 188(1) of Chapter 9 of the Constitution provides the basis upon which the Office of the Auditor-General in South Africa audits and reports on the accounts, financial statements and financial management of the public institutions (RSA, 1996). Thus, the AGSA is one of the key role-players that support the constitutional democracy in South Africa by providing independent assurance on use of tax and other monies by all levels of government.

The AGSA's role is given greater specificity in the body of the Public Audit Act (PAA) (RSA, 2004). The AGSA is expected to be an independent organisation which provides regulatory auditing (on whether the financial statements are fairly presented); on performance auditing (to determine whether the municipal resources are used economically, efficiently and effectively); on computer auditing (to evaluate the integrity of information systems, data and financial transactions); forensic auditing (to facilitate processes of prevention, detection and investigation); and budget auditing (to evaluate whether the planning and budgetary controls and guidelines are followed) (AGSA, 2012/13). The AGSA plays an important role in the municipalities by issuing reports on audit quality. In South African municipalities, it is frequently argued that it is inadequate and incompetent leadership that leads to non-compliance with financial management regulations, and that poor oversight from governance structures results in lower quality audit opinions (COGTA, 2009). Quality audit reports start with compliance with organisational regulations (Sikka, 2009).

In the South African public sector, the AGSA conducts three categories of audit – mandatory audits, discretionary audits and special audits (AGSA, 2011/12). According to the AGSA (2011/12): “Mandatory audits: (means regularity audits), which includes report on the financial statements; report on other and legal and regularity requirements; findings on the report of predetermined objectives; findings on compliance with laws and regulations and status of internal control”. Discretionary audits (means investigations), which includes: “report on factual findings with regard

to financial misconduct, maladministration and impropriety; based on allegations or matters of public interest". Special audits, which includes "report on factual findings, for example, donor funding certificates for legislative compliance; performance audits (including environmental audits); economic, efficient & effective utilisation of scarce resources; and effect of policy implementation, excluding policy evaluation".

Ittonen (2010:8) identifies the role of the audit as one intended to improve the quality of the input data by finding errors and by making process owners more aware of potential errors when preparing their records. This view concurs with the definition of a clean audit outcome. Achieving a clean audit opinion indicates that the financial statements are presented fairly, are free from material misstatements, and that there are no adverse findings in the performance report, nor material findings of non-compliance (AGSA, 2011/12). The IRBA (2012:12-13) outlines the benefits accruing to the performance of public sector audits. These may include the following: improved responsiveness to changing environments and stakeholder expectations; ensuring that the government is held accountable for using resources legally, for the purposes intended, and responsibly, economically, efficiently and effectively; verification that those charged with governance discharge their different responsibilities appropriately, and respond to audit findings and recommendations by taking appropriate corrective action, thus enhancing transparency and accountability. According to the SAICA (2013/14), auditing increases the public's confidence in the entity that has achieved a clean audit. Public sector auditors use the same basic principles, general standards and field standards as private sector auditors in their evaluation of public sector financial statements, achievement of predetermined objectives and compliance with relevant laws and regulations (Shah, 2007:251-253).

### **3.4 AUDIT OUTCOME**

An audit outcome is the auditor's published statement of his opinion of the state of the financial statements (Fahami, et al. 2016). An audit outcome is the last product or service in the accounting chain, and is the independent auditor's expression of an opinion about the state of financial reporting, compliance with laws and regulations and performance information. Such reporting relies on a considerable set of

processes and procedures that enable the auditor to arrive at the published conclusion. The next subsection discusses the various standard audit outcomes.

### **3.4.1 Disclaimer of audit opinion**

The most common description of a 'disclaimer of audit' opinion is explained in Paragraph 2 of the International Standards on Auditing (ISA) in which it states that "the auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive" (SAICA, 2013/14). The AGSA (2011/12) has simplified the ISA's definition, requiring that the auditor gives a disclaimer of audit opinion where "the auditee has provided insufficient evidence in the form of documentation on which to base an audit opinion. The lack of sufficient evidence is not confined to specific amounts, or represents a substantial portion of the information contained in the financial statements" (AGSA, 2011/12:5). In other words, according to AGSA (2011/12), any information provided by the auditee and not supported by relevant documents, is classes as lacking in evidence and the auditor is compelled to provide an inferior opinion, so as to avoid compromising the authority of the better (less suspect) audit outcomes.

According to LaSalle, et al. (1996), auditors are allowed to issue a disclaimer of opinion for entities where the financial statements present the auditors with substantial doubt about the organisation's going concern status. In their study, LaSalle, et al. (1996) ran a logistic regression model on audit opinions regarding going concern uncertainties and disclaimers of opinion. The results indicate that entities receiving a disclaimer are more likely to have more bad news, less good news and weaker internal controls than the entities receiving unqualified audit opinions. In addition, Aobdia (2015) conducted a study of the validity of publicly available measures of audit quality, and found that audit deficiencies are consistent with the issuance of the disclaimer of audit opinion. The disclaimer of audit opinion is therefore an acceptable indication that there are uncertainties in the integrity of the financial reporting that are serious impediments to the audit outcome (Ianniello & Gallappo, 2015).

### **3.4.2 Adverse audit opinion**

According to AGSA (2011/12:5) an 'adverse audit opinion' is to be given when auditors have obtained sufficient appropriate audit evidence, and have concluded that "misstatements, individually or in the aggregate, are both material and pervasive to the financial statements". This explanation also has been derived from the International Standards on Auditing's definition of an adverse of audit opinion of the financial statements of a company where the financial statements have been found to be materially misstated (SAICA, 2013/14). Ryu (2015) investigated the effect of auditor designation on the audit opinion in Korea and found that companies with designated auditors are likely to have greater possibilities of receiving an adverse audit opinion as compared to companies without a designated auditor. The study further showed that the lower quality of financial statements may result in an adverse audit opinion (Ryu, 2015). Thus, the lower quality of audit outcome results from a change in the audit partner (Litt, et al. 2014).

### **3.4.3 Qualified audit opinion**

According to the ISAs, the audit opinion should be qualified when the auditor, having "obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive" (SAICA, 2013/14). The AGSA (2011/12:5) also requires its auditors to issue a qualified audit opinion when the financial statements contain material misstatements in specific amounts, and where there is insufficient evidence for them to conclude that the specific amounts included in the financial statements are not themselves materially misstated.

Furthermore, a qualified audit opinion is issued when the auditor encounters one or two types of financial statements which do not comply with the official frameworks for the presentation of the financial statements. Should management refuse to accept the auditor's proposed adjustments, then a qualified audit opinion is likely to be



issued (Lennox, et al. 2014). The going concern issue also presents the grounds for the auditor to issue qualified audit opinion (Tsipouridou & Spathis, 2014). Although the qualified audit opinion is one of the modified audit opinions available to auditors (disclaimer and adverse opinions being two others), it is not entirely a “bad” report as it draws management’s attention to the organisation’s strengths and (sometimes) significant weaknesses that need to be acknowledged and addressed by management (Ittonen, 2012) in order to improve the audit outcome. Omid (2015) conducted a study in which he investigates the relationship between the qualified audit opinion and accounting earnings management using a multiple regression model. The model was run using data from a sample of 2818 firms in Iran. The study found a positive correlation to exist between qualified audit opinions and accounting earnings management, but not with real earnings management. This would suggest that the International Standards on Auditing should also require that auditors assess two categories of the definition of qualified audit opinion as discussed in the preceding paragraph.

#### **3.4.4 Unqualified audit opinion**

The ‘unqualified audit opinion’ is the most desirable audit opinion in which the auditor communicates information about the quality of financial reporting (Czerney, et al. 2014; Oladipupo & Izedonmi, 2013). Just as in the private sector where the auditor reports on the quality of financial statements, the AGSA (2011/12:4-5) issues an ‘unqualified audit opinion’ when the financial statements contain no material misstatements and there are no findings raised on either the reporting on predetermined objectives or non-compliance with legislation aspects of government business. The International Standards on Auditing indicate that unqualified audit opinions or unmodified opinions indicate that financial statements are free from material misstatements (SAICA, 2014/15).

The unqualified audit opinion gives investors confidence in the financial statements (Jixun & Yanan, 2013) and also guarantees the company’s going concern status (Oladipupo & Izedonmi, 2013). In addition, Fahami, et al. (2016), hypothesised that unqualified audit opinions can influence the relationship between earnings management and stock returns. Their results indicate that a positive relationship

between earnings management and unqualified opinions exists, and that this can influence the stock market to change. However, in their study of auditor-management alignment and audit opinion, Banimahd, et al. (2013) show that there is no relationship between the achievement of an unqualified audit opinion and auditor-management alignment, debt ratio, ownership percentage, firm size and/or auditor change.

#### **3.4.5 The clean audit opinion**

The AGSA (2011/12) defines the 'clean audit opinion' as an indication that the "financial statements of the auditee (which may refer to an organisation being audited or a person and client requesting an audit or being audited) are free of material misstatements (financially unqualified audit opinion) and there are no material findings on the report on performance against predetermined objectives or compliance with key laws and regulations" (AGSA, 2011/12:28). A clean audit opinion is thus only obtainable when the audits of financial statements, predetermined objectives and compliance with relevant laws and regulations are completely free from material misstatements.

The AGSA considers the 'clean audit opinion' to be a fifth type of audit opinion, concluding (or leading) the conventionally accepted progression which includes the 'unmodified audit opinion' (also known as unqualified audit opinion), and descends through the modified audit opinions which include the 'qualified audit opinion', the 'adverse opinion' and the 'disclaimer of audit opinion' (Arens, et al. 2014:79; SAICA, 2014/15). The terms "clean audit" and "unmodified" or "unqualified audit opinion" are thus effectively synonymous (Braiotta, 1999; Stanistic, et al. 2013) and acknowledge that the audited financial statements are free from any misstatements. This type of audit opinion therefore becomes the highest outcome available from the audit process. Stanistic, et al. (2013) formally acknowledge that the unqualified audit opinion is the same as a 'clean audit opinion'. Thus, the use of the term 'clean audit opinion' should only be used when, in the private sector, the auditors find no omissions or misstatements in management's presentation of the financial statements (Tepalagul & Lin, 2015; Amin, et al. 2014; Chen, et al. 2013; Braiotta, 1999; Pei & Hamill, 2013). In the context of South African public sector audits

however, for an auditor to express a 'clean audit opinion' there should be no misstatements in any of the three audit areas - financial statements, predetermined objectives, and compliance with relevant laws and regulations. Thus, in South African public sector audits the clean audit opinion is the equivalent of the private sector's unqualified opinion with no adverse findings (AGSA, 2011/12).

#### **3.4.5.1 Clean audit opinion awareness**

The Collins English Dictionary (2003) defines the word "clean" as "*without anything in it or on it*". In a discussion the researcher held with the AGSA on 12 May 2015, the AGSA laid out the elements that typically describe the clean audit opinion in public sector audit. These include the unqualified audit opinion on the financial statements, compliance with laws and regulations with no material misstatements, and the achievement of predetermined objectives with no misstatements. Thus, the clean audit opinion indicates that the organisation has achieved "full marks" in all three elements of the audit, and that all three sections are without any misstatements. The American Institute of Certified Public Accountants (AICPA) (2014) now describes the 'clean audit opinion' as unqualified opinion or unmodified opinion, so as to prevent confusion when compared with the term used by the International Standards on Auditing (ISA). In South African public sector organisations the use of the term 'clean audit opinion' has been reported as being different from the generally understood 'unqualified audit opinion'. In its local government briefing on municipal finance audits, the South African Local Government Associations (SALGA) (2012a) reported that the concept of the 'clean audit opinion' is a South African "national government initiative and not an international accounting standard".

The fact is that the definition and meaning of the 'clean audit opinion' has been difficult to trace in the Pronouncements of the Auditing Standards; it simply does not form part of the globally accepted types of audit opinions as recognised by the International Auditing and Assurance Standards Board of the International Federation of Accountants (SAICA, 2014/15). As a result, the AGSA, as the country's Supreme Audit Institution and the most important party responsible for audits of public sector organisations in South Africa, has had to developed a formal

definition to provide clarity when the term appears in their annual reporting on public sector audits and associated publications (see section 3.4).

Despite this, a search through auditing literature shows that the use of the phrase 'clean audit opinion' is not a new phenomenon: it has been used since the 1970s (see Septimus, 1979) to mean that the financial statements fairly represent the financial position of the organisation, and are consistent in their presentation and in accordance with a recognised accounting frameworks. Thus, the clean audit opinion is only used to describe situations where financial statements are free from any misstatements, while in the South African public sector auditing the term is used to describe the situation where the unmodified audit of financial statements are 'clean', AND there is full compliance with the applicable laws and regulations (with no material misstatements), AND the audit of predetermined objectives is without material misstatements. The Minister of Cooperative Governance and Traditional Affairs (COGTA) at the time, Mr Siqecha, in 2009 launched "Operation Clean Audit" in his Foreword to the ministry's Business Plan 2010-2011. This was one of the thirteen local government priorities announced at the time, with the specific expectation that by 2014 "all provinces and municipalities should have clean audits" (COGTA, 2009). It is apparent now, with perfect hindsight, that achieving a national clean audit opinion, as the sum of the unmodified audit of financial statements, plus compliance with laws and regulations with no material misstatements, and plus the audit of performance information, was a task that needed more than the five years initially allocated, possibly because there was only superficial understanding of the depths of the problems faced by municipalities in particular.

Despite the fact that awareness of the clean audit goal is relatively good, as is the recognition that to achieve this needs effective governance and an acceptance of accountability, there are still deep-rooted problems in the municipalities. Of these problems the main ones are: political factors; lack of understanding and will to implement policy and legislative directives; weaknesses in accountability systems; shortages of capacity and skills, as well as weak financial management systems (AGSA, 2014). In the period leading up to the launch of the initiative, the municipalities had been increasingly failing to report efficiently and effectively on their financial statements. The depth of the problems was becoming obvious to the

entire country as the service delivery protests across the country became an almost continuous feature of news broadcasts. Concurrently with these outbreaks of protest, the municipalities consistently received poor audit outcomes, with those of the 2007/08 financial year being sufficiently bad to result in the initiation of “operation clean audit” in 2009 (AGSA, 2007/08).

As a result, the COGTA initiated the campaign to turn around the management and operations of local governments in South Africa, by responding to the challenges faced by the municipalities. The AGSA (2007/08) identified the major challenges facing all the municipalities in the country. In this regard, as the AGSA’s report revealed, only one (1) municipality received a clean audit opinion in financial year 2007/08. The main challenge identified by the AGSA was that the chief financial officers (CFOs) were not fully involved in the preparation of their municipalities’ financial statements, relying instead on outside consultants to prepare the financial statements for them. In some cases, the poor management of financial records was also a major problem, resulting in disclaimer audit opinions for 99% (for 2006/07) and 86% (for 2007/08) of the municipalities (AGSA, 2007/08). This also indicates that the accounting officers were not demonstrating accountability in the management of records of the municipalities’ assets. These shortcomings were being perpetuated by the failure of the AOs to implement audit recommendations and instructions; this effectively identified the root cause as poor administrative and political leadership in local government structures. In practical terms, this resulted in the collapse of administrative and political functions. All these weaknesses and failures in the administration and operations of the municipalities were repeatedly highlighted by the AGSA in its annual reporting of audit outcomes to Parliament.

With this initiative, the COGTA (as the ministry responsible for local government), took the initiative and identified the parties they believed able to take responsibility for effecting a turnaround in the functioning of local governments. The initiative included the preparation of a comprehensive turnaround strategy document (COGTA, 2009), which provided guidelines for achieving effective service delivery. Arising from this initiative was the formal development and implementation of “operation clean audit 2014”. The parties identified as key to the initiative’s success included the executive authorities (political leadership) at local government levels,

municipal and provincial accounting officers, provincial treasuries, national treasury and the Auditor-General. In addition, it was intended that all municipal employees and office-bearers should be made aware of the clean audit objective, to enhance the support given to the effort.

Despite the widespread use of the term 'clean audit opinion' by users of public sector financial statements and by the AGSA, the term still confuses the general public. When a municipality receives an 'unqualified audit' (as opposed to a 'clean audit opinion', and this is more commonly achieved than the latter), the community and the public at large begins to perceive that municipality as one of the examples of good management, and assume that they are successfully responding to the service delivery needs of their communities. In other words, it is assumed that an unqualified audit opinion also means that there are no service delivery problems in such a municipality. The point is that an 'unqualified audit' simply means that the municipality has generated a reasonably accurate story of what happened to the money and resources. The difference between a 'clean audit opinion' and an 'unqualified audit opinion' is deceptively simple: a municipality achieving a 'clean audit' report *knows* where the money came from, knows where it went, AND knows that it went to pre-approved projects and allocations, AND that the processes followed were legal. Phillips (2015) indicates that the clean audit opinion is used as an indication that financial statements are of substantial value to the users and the citizens. In other words, the clean audit opinion confirms that the municipality is running its financial affairs in an orderly manner and meeting its service delivery targets, and that this is being done in full compliance with relevant laws and regulations.

While the clean audit concept may be considered as different from the unqualified audit outcome by a majority of users of financial statements in South Africa, and by the recipients of the services delivered by the public sector, the concepts have been used synonymously in the United States of America for some decades (Septimus, 1979). The Auditor-General South Africa is an enthusiastic user of the expanded 'clean audit' concept (far more so than is common amongst the private sector audit firms), especially when attempting to recognise the most favourable and desirable of audit opinions in the South African public sector context.

Ittonen (2010) asserts that the audit opinion is intended to provide useful information to the users of financial statements. The 'clean audit' outcome is the most desirable audit opinion available to the South African government's external auditors. Its acceptance seems to have finally been assured in that it is now in regular use in mainstream print media (CityPress, 2014) and especially in their business reports. While van der Waldt (2012) and Mazibuko and Fourie (2013) posit that achieving a 'clean audit' opinion is an indicator of a clean administration, the unqualified or unmodified audit opinion is a close second, in that the financial statements are presented fairly and are free from material misstatements (Arens, et al. 2014; SAICA, 2014/15). These two terms have historically been used interchangeably (see SAICA Handbooks, 2014/15) in the private sector audit world, but there the term "clean audit opinion" does not include the reviews assurances and other services engagements by the International Auditing and Assurance Standards Board (IFAC, 2014).

According to Leung, et al. (2009:199), an unmodified audit report is the "most common type of opinion issued", and it contains an assurance that the financial statements present fairly, in all material respects, the financial position of the entity, and reflect the results of operations and cash flows of the entity in accordance with applicable accounting standards, other mandatory professional reporting requirements and relevant statutory and other regulations. This conclusion indicates that the auditor has formed an opinion that is based on the outcome of an audit performed in accordance with recognised, generally accepted auditing standards (IFAC, 2014). Leung, et al. (2009) recognise the auditor's report, when issued in compliance with the ISA – 700, as a general purpose financial report, and thus not entirely fit for government audit purposes.

The AGSA's audit of public sector organisations takes place in three phases: the audit of financial statements; reporting on predetermined objectives; and compliance with laws and regulations (AGSA, 2011/12). Table 3.2 provides some detail of each of the three elements of a public sector audit.

**Table 3.2: Elements of a public sector audit**

<b>Financial statements</b>	<b>Compliance with laws and regulations</b>	<b>Audit of predetermined objectives</b>
1. Trial balance 2. Financial position 3. Financial performance 4. Cash flow statements 5. Disclosure and notes	1. Framework to prepare financial statements 2. Supply chain management policy 3. MFMA 4. Treasury Regulations	1. Strategic plan 2. Operating plan and budgeting 3. Information reporting 4. Performance indicators 5. Set performance targets

**Source: Adapted from AGSA (2011/12)**

Thus, the path to the achievement of a ‘clean audit’ includes the successful evaluation of an integrated set of financial statements, an assessment of the degree of compliance with laws and regulations the organisation has achieved, and an evaluation of information describing the performance against predetermined objectives. These elements are discussed next.

**a) Audit of financial statements**

Financial statements include “... statements consisting of the balance sheet; income statements; a cash flow statement; any other statements that may be prescribed; and any notes to those statements” (SAICA, 2013/14). These statements are structured representations of historical financial information that include the assessment of the entity’s financial position as shown in the balance sheet’s presentation of assets, liabilities and equities; the financial performance as presented in the income statement’s record of income and expenses; and the statements of changes in financial position which are reflected in the income statements and in changes in the balance sheet (SAICA, 2013/14). An audit is conducted to determine whether the financial statement as a reflection of the financial position, financial performance, and cash flow, and that the presentation and (statutory) disclosures have been stated in accordance with specific criteria (Arens, et al. 2014; SAICA, 2014/15). In the South African local government financial



arena the “suitable criteria” determining the preparation of the financial statements (and thus the audit) are the Generally Recognised Accounting Practice (GRAP) Standards (IRBA, 2012). These criteria are designed to provide users (such as Parliament, the provincial legislatures and municipal councils) with information on the basis used for the preparation of the financial statements, and to assist them to assess whether proper stewardship has been exercised; to assist preparers of financial statements (such as accounting officers (AO)) to apply GRAP accurately and effectively; to assist the auditors in forming an opinion as to whether the financial statements conform with GRAP; to assist users of the financial statements to interpret the information contained in the financial statements; and to provide the executive authority with a conceptual basis for the formulation of refinements to the GRAP (National Treasury, 2005).

**b) Audit of compliance with laws and regulations**

Compliance audit is conducted to determine whether the auditee has followed the specific procedures, rules and regulations set by the authorities (Arens, et al. 2014:33). In the municipalities such compliance is measured against a number of laws and regulations applicable to local government, the public sector and municipal entities. The key laws and regulations include the Municipal Finance Management Act (MFMA) 56 of 2003 (RSA, 2003), and the Municipal Systems Act (MSA) 32 of 2000 (RSA, 2000). Thus, it is imperative that the auditors are more than simply aware of these pieces of legislation and in fact have a working knowledge of the application of these laws and regulations to a local government entity so that they are able to identify instances of noncompliance with these laws and regulations during their audits (IRBA, 2012).

The results of compliance audits are normally reported to management of the entity as they have the primary responsibility to correct any deviation from applicable laws and regulation (Arens, et al. 2014:34). However, in the South African public sector as a whole, the AGSA makes all findings public, including instances of deviation from legislation, rules and regulations applicable to the public sector. Thus, once the compliance audit has been completed, the auditor can place reliance on the systems

of internal controls and perform procedures based on the applicable rules and regulations.

**c) Audit of predetermined objectives**

According to the IRBA (2012:9) the 'audit of predetermined objectives' is not unique to South African local governments. Australia, Canada and New Zealand also audit public sector performance information. In the research literature and the operational reporting guidelines on this subject, the terms 'audit of performance information' and 'audit of predetermined objectives' are used interchangeably, as evidenced recently in the study by Van der Nest and Erasmus (2013), and in the AGSA's official documents (2009). An 'audit of performance information' is defined as the audit of reported actual performance against predetermined objectives of public institutions, to provide assurance to Parliament, legislators, members of the public and other interested parties that the actual performance reported is both useful and reliable (IRBA, 2012). Van der Nest and Erasmus (2013) argue that the audit of performance information is a cornerstone of performance reporting. According to the IRBA (2012), the audit of predetermined objectives requires the auditors to provide an opinion on whether the reported performance information accurately reflects the performance of the auditee against its predetermined objectives.

The audit of predetermined objectives has been mandatory since the start of the 2005/06 financial year (AGSA, 2011/12), and the first audit opinions were presented in the 2009/10 financial year (AGSA, 2011/12). This was used to conclude that the reported performance against predetermined objectives was useful and reliable (IRBA, 2012). Today, the audit of performance information has become an accepted part of the evaluation of public sector organisations and a necessary prerequisite to obtaining a clean audit outcome (Van der Nest & Erasmus, 2013).

In the South African public sector organisation, performance information follows the framework in which performance management and the reporting of the performance information is managed (AGSA, 2011/12). Audit of performance information can be used to measure public sector entities' track records of service delivery against the SMART [as being specific, measurable, achievable, realistic and time related] way of

doing things. Performance audits are performed in terms of Section 20(2)(c) and 28(1)(c) of the Public Audit Act (RSA, 2004) which requires that an audit report be generated to reflect an opinion or conclusion relating to the performance of the auditee against predetermined objectives.

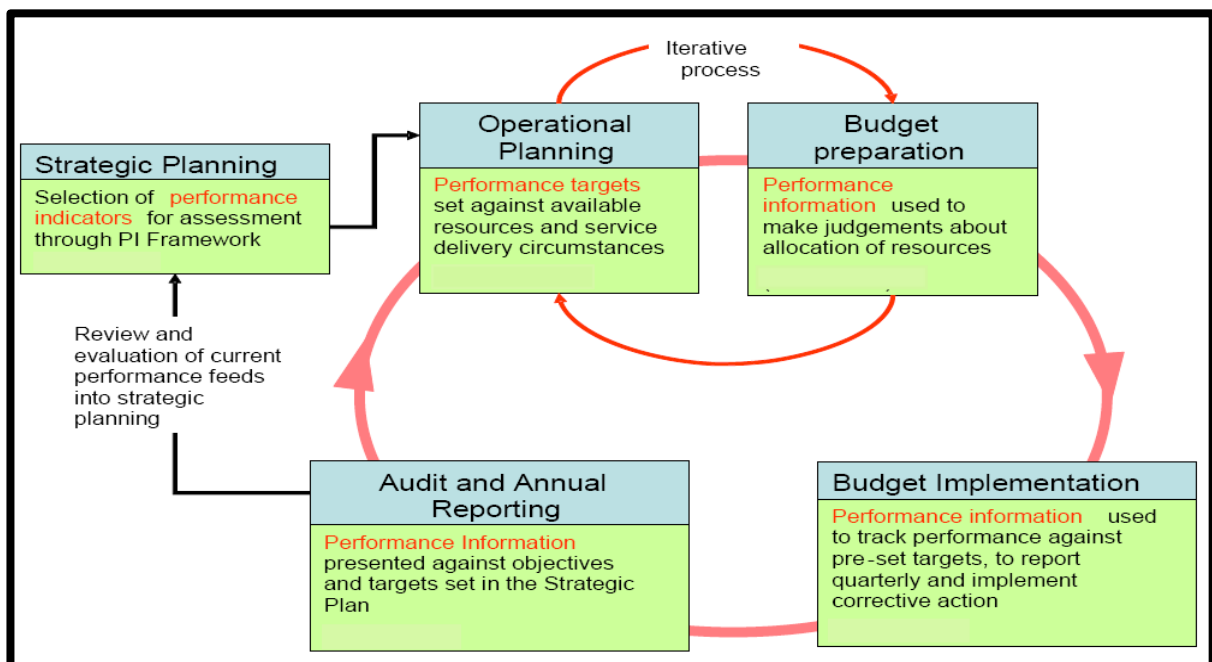
In support of the public's right and need to know how government money has been used, the audit of performance information serves to provide information that is complete, understandable, comparable, relevant, and reliable to the public and other users of audit reports (National Treasury, 2011), and should be made available in a timely manner. In public sector organisations the audit is an important component of accountability that extends to non-financial information as well. Consequently, the auditors are expected to provide assurance on the reliability of non-financial information relative to the entity's predetermined strategies, and also to provide appropriate assurance as to whether there are in fact clear frameworks against which to audit the information.

In South African public sector organisations, the processes to be followed when auditing performance information are detailed in the National Treasury Performance Information Handbook (National Treasury, 2011). This handbook indicates that the AGSA is expected to audit performance information against all relevant laws and regulations, while making use of the frameworks for managing performance information. In addition, the auditors are required to refer to the circulars and guidance issued by the National Treasury and the Presidency regarding planning, management, monitoring, evaluation and reporting in the conduct of their audits. The IRBA (2012:82) also provides guidance to the AGSA on how to audit performance information in the public sector.

Thus, when the audit of performance information is conducted, all relevant laws and regulations, together with official frameworks for the managing of programmes and their performance information, and frameworks for the preparation of strategic and annual performance plans should be considered (AGSA, 2011/12). In addition, the circulars and guidance issued by the National Treasury regarding planning, management, monitoring and reporting of performance information should be considered as useful tools for audit purposes (AGSA, 2011/12). According to the

IRBA (2012), performance information is audited against the criteria of existence, timeliness, presentation, measurability, relevance, consistency, validity, accuracy and completeness.

Despite the number of performance information audit evaluation tools presented for use by individual departments and auditors, section 85(2)(c) of the Constitution gives The Presidency of the Republic of South Africa an overall authority (together with other members of the Cabinet) to coordinate the functions of state departments and their administrations (RSA, 1996). The aim of the performance evaluation framework in public service institutions is to encourage public service institutions to evaluate their programmes regularly; to offer guidance on the approach to be adopted when conducting evaluations; to provide for the publication of the results of these evaluations (National Treasury, 2011), and thus to enhance accountability in order to expedite the realisation of their service delivery targets. Figure 3.1 illustrates the interrelationships of the most typical information needed for the audit of predetermined objectives.



**Figure 3.1: Process of auditing predetermined objectives (Source: National Treasury, 2011)**

The above iterative process was developed based on the understanding that:

- *Strategic planning* is a process of defining an organisation's plan for achieving its mission (Gates, 2010). Thus, the strategic plan is concerned with an institution's policy priorities, and programme and project plans for the longer and shorter terms (Pauw, et al. 2009). According to Pauw, et al. (2009:88), the strategic plan must clearly set out and promote the managing processes of the institution; ensure that all citizens benefit from the rendering of these services; enhance accountability, and provide greater transparency and value for the public.
- *Operational planning* takes place at the organisational unit level (Hinton, 2012). At the organisational level, the presence of an operational plan helps auditors to evaluate performance against strategic objectives (National Treasury, 2011). At the operational plan level, municipalities are required to focus on converting service delivery objectives into action (Pauw, et al. 2009). Thus, the operational plan shows how outcomes such as improved service delivery, greater commitment on the part of the organisation's staff, and improving levels of customer satisfaction on the back of improved service delivery are to be achieved (National Treasury, 2011).
- *Budget preparation* helps the organisations to plan and control their operations and to support their managerial strategies (CIMA, 2008). This has to be viewed as a key policy document (Blöndal, 2003) which takes cognisance of all government revenue and expenditure constraints. Regardless of the context (whether national, provincial or local government), a budget is set out to determine what funds are available and how these are to be allocated to best deliver agreed services (National Treasury, 2010). In South Africa's local governments, budget preparation is a long process. It starts in August of every year, when the municipal mayors table the schedule of key deadlines, and concludes in June or early July of the following year when the municipal mayor approves the Service Delivery and Budget Implementation Plan (SDBIP) and the associated annual performance agreements with senior managers (National Treasury, 2012). Hence, the budget preparation process includes the Integrated Development Plan (IDP) review (where community inputs are encouraged through discussion), and efforts to promote a better understanding of community needs, by providing opportunities

for community feedback: in short, it is the sum of all efforts intended to improve accountability and responsiveness to the needs of the local communities (National Treasury, 2012).

- *Audit and annual reporting:* The AGSA (2011/12) performs and oversees the audit and annual reporting of the auditees (municipalities, departments and state owned enterprises amongst others), testing their annual performance reports on their actual achievements against the performance objectives they had set at the beginning of the period. For audit purposes, the accounting officer should consider measurable performance objectives, which is another important aspect that is required to be aligned to the budgeted financial outcomes (National Treasury, 2012).
- *Budget implementation:* According to Pauw, et al. (2009:130) budget implementation is the phase where the appropriate cash is used to purchase or pay for services contracted for in terms of the government policies underpinning the budget. This is an internal process in which municipalities are expected to implement service delivery projects defined by revenue source, and operating and capital expenditures by type (National Treasury, 2012). Budget implementation is dependent on good budget preparation. A good budget ensures direct expenditure management that avoids unauthorised, irregular and fruitless and wasteful expenditure. In the local government sphere, the budget implementation phase involves the fulfilment of plans outlined in the budget, through the approval of the Service Delivery and Budget Implementation Plan (SDBIP). This in turn requires accurate and binding performance agreements for municipal managers and other senior managers for the coming financial year. These performance agreements must be concluded within 28 days of the approval of the budget (National Treasury, 2005).

The AGSA has a constitutional mandate and, as the supreme audit institution of South Africa, it exists to strengthen the country's democracy by exercising oversight, accountability and governance duties over the activities of the public sector through auditing. In so doing it contributes to the nurturing of public confidence in government's ability to deliver on its promises. Recently, the AGSA expanded its range of services beyond the basic financial audits to include a wide range of audits

of pre-determined objectives. Thus, the audit of performance information is becoming increasingly commonplace, and should be an automatic and integral part of an effective accountability audit in all public sector organisations. In South Africa's municipalities, as in most national governments departments in the country, it is a legislative requirement for accounting officers to report on the performance of their organisations against their predetermined objectives. This is required in terms of financial management statutes such as the Public Finance Management Act 1 of 1999 and the Municipal Finance Management Act 56 of 2003. As part of the legislative accountability framework, performance reports are primarily used by legislatures, members of the public and other interested parties to assess the relative success of service delivery efforts, and whether funds approved by the national and provincial legislatures and municipal councils have been spent correctly. As a result, there is in fact no separate audit opinion available to public sector organisations for their financial statements only. For the auditor to express a 'clean audit opinion', all three elements of compliance must be considered: financial statements; compliance with policies, laws and regulations, and performance information must all be audited and all have an impact of the formulation of the audit opinion.

According to AGSA (2011:16), "clean audit does not mean that all is perfect in government – it thus simply means that [the] control environment is sound enough to prevent and detect any imperfections early enough" to prevent serious impact on budgets and service delivery objectives. Thus, the achievement of clean audits across all entities would guarantee a clean administration (Makhura, 2014; AGSA, 2011/12). A clean administration is a necessary prerequisite for effective service delivery and for ensuring the growth and continued strengthening of the South African democracy (Public Service Commission, 2013). According to China's then President Ma Ying-Jeou (2008), a clean administration is characterised by the demonstration of the core values of integrity, professionalism and efficiency by its public sector officials. The term "clean administration" became a catch phrase in the twentieth century. It is an ideal to which politicians, parliamentarians and government administrators claim to aspire, and is characterised by a government that is free from corruption, social ills, and management control weakness, and that adheres to the laws, rules and regulation of its country. "Administration" is another catch-all term,

one that refers to “all the systems, procedures, codes, policy frameworks, accountability mechanisms and management controls that ensure the functioning of public administration” (Public Service Commission, 2013). From the perspective of South Africa’s Constitution (section 195(1)), “Public administration must be governed by the democratic values and principles enshrined in the Constitution...” (RSA, 1996). The nine principles guiding the activities of a clean administration are then listed in this section. Thus, a clean administration is expected to: promote and maintain a high standard of professional ethics; promote efficient, economic and effective use of resources; be development oriented; provide such services impartially, fairly, equitably and without bias; respond to people’s needs and encourage public participation in policymaking; be accountable to the public; foster transparency by providing the public with timely, accessible and accurate information; ensure good human resource management and career development practices to maximise human potential; and ensure broad representation of the South African people, with employment and personnel management practices based on ability, objectivity, fairness, and the need to redress the imbalances of the past to achieve broad representation (RSA, 1996).

In the same vein, Madonsela (2013) states that a clean administration should also demonstrate the following: “capacity building through training, particularly policy inductions and regular briefings when policies change; provision of easily digestible materials such as pocket books and posters on key policy provisions and concepts; celebrating and rewarding compliance; consistent rejection of non-compliance; zero impunity for non-compliance; a cooperative rather than competitive paradigm among integrity institutions, including internal ones; strengthening synergies in oversight value chain; learning and growing together; overseers walking the talk on good governance; better protection of whistle-blowers; and adherence to a rule of law paradigm”.

Clean audits reflect clean government, and a clean government depends on a clean control environment. In order to understand the correlation between clean government and a clean control environment, Makhura (2014) considers the elements of a good control environment that are prerequisite to the enhancement of



the integrity of all local government institutions. As previously stated, a clean control environment depends on clean government. From an accounting perspective, the control environment is a key element of internal control (COSO, 2013), and embodies integrity and ethical values; commitment to competencies, and the participation of those charged with the responsibility of governance. In addition it requires a supportive management philosophy and operating style; organisational structure; appropriate assigning of authority and responsibility, and human resource policies and practices based primarily on competence (COSO, 2013).

Clean administration emerges when governance of the control environment is effective. Some of the authors reviewed observed that implementing a 'clean administration' has proved effective in improving the functioning of local government (Soomro & Chandio, 2013). Where a clean control environment exists in local government, the attitudes, awareness and actions of local officials and management are in line with those identified by best practice and regulations (COSO, 2013), and this will provide the impetus to achieve clean audit outcomes. Within the context of this study, the control environment shapes the attitudes of the stewards, encouraging them to commit themselves to high standards of integrity and ethical values, and clear and effective communication, while appointing the people with appropriate qualifications, competencies and work ethics (Deloitte, 2012; Matziliza, 2013). Hence, a clean administration is built by the strengthening of anti-corruption measures; upholding public-sector ethics; promoting corporate credibility; expanding [the availability of] public guidance; increasing efficiency and transparency; enhancing the openness of government procurement; ensuring fair participation in politics, and participating in international cooperative efforts. In addition, a clean administration enhances the number and ease of transnational exchanges, prevents money laundering, and provides effective mutual assistance in law enforcement (Ma, 2008). Therefore, a well-controlled administrative environment effectively guarantees a clean local government administration and also assures the welfare of the entity's citizens. Thus, a clean government administration is one that puts the principles of the Constitution into daily use, ensuring there is no element of corruption or abuse of power, and that it is responsive to the needs of its citizens.

### 3.4.5.2 Drivers of improved audit outcomes

A quality audit depends on good internal control. The AGSA identifies three key drivers to be paramount for effective internal control and hence the audits of the municipalities are focused on determining the strengths of these three drivers (AGSA, 2013). The key internal control drivers are leadership, financial management and governance (AGSA, 2013). These drivers are discussed next.

**Leadership:** Municipal leadership is required to establish a culture of honesty, ethical business practices and good governance; to exercise oversight responsibility; to ensure effective human resource practices; to implement appropriate policies and procedures; to approve and monitor the implementation of action plans; to address internal control deficiencies, and to approve an appropriate information technology governance framework (AGSA, 2011/12). Missioura (2015) agrees that leadership has a critical role to play in monitoring the internal controls environment, to ensure that it contributes to the implementation of effective and efficient management systems. Efficient, ethical leadership is essential to safeguard and maintain the integrity of internal control systems because they influence accounting systems (Arel, et al. 2012). Leadership quality is thus an important determinant of the success of the organisation. Similarly, Simons (2013) regards leadership to be a lever of control that drives the organisation's strategic direction and ensures proper processes in policy formulation and implementation. In addition, Ho, et al. (2015) in their study of the relationships between the Chief Executive Officer, gender, ethical leadership and accounting conservatism, revealed a positive association, and suggest that ethical leadership should contribute to the greater integrity of financial internal control reporting. Leadership is at the top of management's decision-making pyramid (Ho, et al. 2015), and weak leadership may therefore result in poor decisions that will affect the audit outcome (Skaife, et al. 2013).

**Financial and management** requires the use of a recognised record-keeping system for all transactions; the maintenance of effective controls over daily and monthly processing and reconciling of transactions; the production of regular, accurate and complete financial and performance (service delivery) reports; the review and monitoring of compliance with applicable legislation, and the design and

implementation of formal controls to mitigate information technology risks (AGSA (2011/12). McKinney (2015) views effective financial management in the public sector and non-profit organisations as an important component of the enhancement of timely reporting and quality of audit outcomes. Of course, financial managers also have a primary responsibility to prepare financial statements for audit. Therefore, by fine-tuning their internal controls over financial reporting organisations can improve their audit outcomes (Pett, et al. 2015). On the other hand, when the financial management environment is effectively operated, in accordance with accepted standards and processes, the auditors are also better able to evaluate the financial statements, financial risks and reporting lines (McKinney, 2015; Pett, et al. 2015).

**Governance:** Those entrusted with responsibility for governance should ensure that risks are identified, assessed and effectively mitigated; should ensure the maintenance of an adequately resourced and functioning internal audit unit, and should require that the audit committee performs its legislated duties competently. In addition they should promote accountability and service delivery (AGSA, 2011/12). Effective governance optimises the use of resources to ensure proper internal control systems (Cao, et al. 2015; Lisic, et al. 2015). In addition, Lisic, et al. (2015) emphasise that the audit committee has the power to ensure that internal controls are effective and support the financial reporting processes. Hence, the whole governance structure has as its prime focus the optimisation of internal controls and improving the quality of audit reports (Cao, et al. 2015; Lisic, et al. 2015).

These three key drivers of improved audit outcomes will be discussed in their own individual chapters next.

### **3.5 SUMMARY OF THE CHAPTER**

This chapter provided a conceptual background to the study. It was identified that auditing in the South Africa public sector is one of the cornerstones of good governance, as it provides an independent assessment of financial management and evaluation of government systems. Thus, auditing in the public sector increases public confidence by ensuring that public resources are safeguarded and are being used efficiently and effectively. In the South African local government arena,

municipal audits are performed by the Auditor-General, who has a Constitutional mandate to strengthen governance in the public sector. Auditors are thus also expected to express an opinion on the fairness of the financial statements of the local governments they audit. The concept of a 'clean audit' opinion has been refined by the AGSA to indicate an outstanding audit opinion arising from the audit of financial information and performance information and compliance with legislation and regulations. This chapter also discussed the awareness of the 'clean audit opinion', and identified the drivers of improved audit outcomes as residing in leadership, financial management and governance. Chapter 4 presents a literature review on municipal leadership and audit quality.

## **CHAPTER 4**

### **MUNICIPAL LEADERSHIP AND AUDIT OUTCOME**

#### **4.1 INTRODUCTION**

This chapter reviews the existing literature on six topics: the concept of leadership; leadership and audit outcomes; leadership accountability; leadership in local government; strategic leadership, and ethical leadership. Reviews of the literature helped to identify similar studies on these topics, which then provided evidence of potential research gaps ripe for further study. The chapter concludes with a summary of the issues explored.

#### **4.2 LEADERSHIP AND AUDIT OUTCOME**

This subsection discusses the concept of leadership and the link between leadership and audit outcome.

##### **4.2.1 Concept of leadership**

Leadership is a process of influencing followers in order to achieve organisational objectives through change (Lussier & Achua, 2007:6). Leadership in the local government sphere is one of the phenomena that everyone talks about and usually relates to issues of financial management and governance. Thus, leadership is viewed as a type of human social leadership that seeks to mobilise electorates to accept policy prescriptions intended to address their problems (Masciulli, et al. 2009). In the context of local government, improvements to both administrative and political leadership are regarded as the answer to the problems of poor audit outcomes (AGSA, 2009/10).

Leadership is defined as the ability of a person to move an organisation towards the achievement of goals and objectives (Ricketts & Ricketts, 2011:5), and it is also viewed as an influencing process to drive the vision (of the leaders and/or the organisation's membership) thereby to achieve quality results (Frigo, et al. 2012;

Lussier & Achua, 2007). Similarly, Hughes, et al. (2006:1) argue that leadership is not about position, but an ability to influence. Manning (2002:18) further argues that it is not simply a formula, where organisations and people simply put in place the processes, systems and support structures to build a leader. It requires strategies to successfully achieve the desired outcomes (Frigo, et al. 2012; Lussier & Achua, 2007; Jarzabkowski & Kaplan, 2015; Waters, 2013).

There is a growing body of literature on leadership, each author building upon the ideas and theories of the previous research findings (Bolden, et al. 2003; Grint, 2014; Sethuraman & Suresh, 2014; Quong & Walker, 2010; Salehzadeh, et al. 2015). According to Lussier and Achua (2007:17), the study of leadership has a practical value as it is used to better understand, predict and control the business' outcomes. The premise of this concept of leadership is largely uncontested (Day & Antonakis, 2012; Horner, 1997), and is effective in the debate (Schoeman, 2012) to define individual levels and degrees of accountability (Said & Jaafar, 2014). Similarly, the most cited concept of leadership in general discussion is called the Great Man theory, which was popular among professionals and leaders in the 1900s (MacArthur, et al. 2011:2).

Grint (2014:3) indicates that the concept of leadership has continued to evolve throughout history, and is not dependent upon the existence of written text. Of course, the qualities of leadership were perceived as predominantly male, and were most easily observed in military and political groupings (MacArthur, et al. 2011:2). This was a very optimistic view of leadership, resting on the belief that leaders are highly influential people due to their personal charisma, intelligence, wisdom, and political skills, and that leaders are born and not made (MacArthur, et al. 2011:2). The emergence of the alternative concept of leadership – that there is a significant body of skills and attributes that can be learned – has ensured that the concept of leadership remains a major issue both in theory (published literature), and in practice, as noted by Bolden, et al. (2003:6). Nevertheless, most would agree that leadership's prerequisite is the presence of a force of personality (Joseph, et al. 2015; Maslanka, 2004).

More recently, the twentieth century has seen the emergence and growing prominence of the behavioural theory of leadership (Maslanka, 2004:8). This theory focuses on what leadership is doing, rather than the qualities and personalities of its office-holders (Bolden, et al. 2003:6). It manifests in some form in all good leadership behaviour (Joseph, et al. 2015; Stuke, 2013; Trainor & Velotti, 2013). It goes without saying that the important issues facing leadership today are highly complex and manifest across multiple disciplines, giving rise to the contingency theory of leadership, which holds that no leadership is totally correct all the time (MacArthur, et al. 2011:3). According to Bolden, et al. (2003:6) this type of leadership is able to identify factors that best predict effective leadership to fit particular circumstances. Since it recognises that a particular leader does not have the qualities needed to address every leadership situation the organisation faces, Salehzadeh, et al. (2015) have coined the phrase situational leadership to describe the narrower focus needed to address specific and frequently highly technical issues. According to Sethuraman and Suresh (2014:166), a situational leadership approach requires that leadership should be chosen on the basis of the situation being faced (or about to be faced) by the organisation. This is because leadership is not a one-size-fits-all commodity, and there are differences in leadership style and appropriateness at every level in the same organisation (Bolden, et al. 2003:6; Salehzadeh, et al. 2015:4).

Nasomboon (2014) posits that leadership is important in promoting and improving organisational effectiveness. The goal of improved organisational effectiveness can be achieved through transactional leadership which requires (the supreme) leadership to reward (team) leaders for completing specific tasks, and for high achievement (Bolden, et al. 2003; Shah, et al. 2015). This type of a leadership emphasises the importance of the relationship between a leader and a follower (Bolden, et al. 2003:6), and also focuses on the benefits the leader delivers in return for the commitment and the loyalty of the followers. Of course, another consideration is given to the concept of a transformational leadership, which focuses on the changes needed in the organisation, and the role of leadership in creating something new out of the old (Bolden, et al. 2003:6; Horner, 1997:274). A transformational leadership style embraces a process in which leaders take action to try to increase their organisation's (and individual colleagues') awareness of what is right, while

upholding ethics and values beneficial to the greater society (Bolden, et al. 2003; Guay, 2013).

As discussed in the preceding paragraphs, in the effort to understand the way leadership provides value it is equally important to understand the historical development of the concept of leadership. Grint (2014:13), for example, provides a sequence or time series in which specific characteristics of leadership were most prominent. Thus, the concept of leadership in the 1900s is described by the “Great Man” theory; in the period 1910 - 1920s the concepts of scientific management and Taylorism and Fordism predominated; during the 1930s - 1940s the concepts of Hawthorne, /human relations, mass, and traits and charismatics came to the fore. By the 1950s to 1970s Contingency Theory, systems analysis, self-actualisation, and the theories of Maslow and McGregor dominated the study of leadership; from 1980 to the 1990s transformational leadership, corporate culture, quality circles, and tough love were the buzz-words; and from 1990 to 2000s the New Public Management, and Business Process Reengineering movements dominated, along with understanding competencies, and benchmarking targets. Psychometrics also moved to centre stage. Current thinking is now focused on the concepts of distributed leadership, followership, identity, and “Mission-Command” (Grint, 2014:13).

As the historical development of the concept of leadership outlined above suggests, and Mostovicz, et al. (2009) confirm, leadership is dynamic and also complex (Waters, 2013), and is increasingly adaptable and flexible. Interestingly, current thinking suggests that the role of leadership can be separated from the management function (Sethuraman & Suresh, 2014:166; Daft, 2005:16). According to Daft (2005:16), the management function can be separated from leadership as management focuses on the attainment of organisational goals in an effective and efficient manner through planning, organising, staffing, directing and controlling of resources, while leadership predicts and control the outcomes (Lussier & Achua, 2007:17). This means leadership can be separated from management. As Manning (2002:34) argues:



- *Leaders* are not always obvious before they become leaders: this refers to the people who by every criteria seem quite unremarkable one day, and prove utterly outstanding the next.
- *Leaders* need a chance to lead: power and influence are critical assets gained through promotions, mentorship, favouritism and connections.
- *Leaders* need things to go their way if they are to shine: this could very well demonstrate that they can meet trouble head on and still win.
- *Leaders* come in every shape, size and personality and from every kind of background: this means some leaders may be born with what seem to be sharp minds, strong bodies, wealthy and well connected parents. Others, from far humbler backgrounds, nevertheless manage, through education, being exposed to interesting people, and being encouraged to have confidence, to make good use of every chance they are given to excel (Manning, 2002:34).

Clearly, the concept of leadership requires an ability to be proactive, to implement a strategic vision, and an ability to convince followers of the appropriateness of the vision and the strategic direction. Leadership is a process of influencing followers in order to achieve organisational objectives through change (Lussier & Achua, 2007:6). Leadership in the local government arena is one of the phenomena that everyone talks about, and most often relates to issues of financial management and governance. Thus, leadership is viewed as a type of human social leadership that seeks to mobilise electorates to accept policy prescriptions as solutions to their problems (Masciulli, et al. 2009). In the context of local government, both administrative and political leadership is regarded as holding the answer to the problems of poor audit outcomes (AGSA, 2009/10). Hence, the next section discusses the link between leadership and audit outcome.

#### **4.2.2 Link between leadership and audit outcome**

Audit outcomes have become a concern for South African local governments, since local governments continue to fail to achieve clean audit opinions. This situation has raised concerns about the quality of municipal leadership because there is a generally accepted positive correlation between audit quality and leadership quality.

These concerns have attracted even greater attention because local governments in South Africa provide, on behalf of national and provincial governments, delivery of key services for housing, water, and electricity, amongst others, that improve the lives of the people. The following subsection summarises the relationship between leadership and audit quality.

Recently published research has linked audit quality and leadership (Webb, 2015; Francis, 2004; Jelic, 2012; Otley & Pierce, 1995; Krohmer & Noël, 2010; Rahimi & Amini, 2015). These researchers show that audit quality is higher when leadership independently executes its responsibilities. Francis (2004) supports this observation when he makes a call for leadership not to interfere with the administration and audit activities. Thus, the implication is that leadership is to be blamed for poor audit quality. Otley and Pierce (1995) examined how subordinates' reactions to control systems is influenced by the leadership behaviours of supervisors. Their findings indicate that a leadership style characterised by a rigid and highly structured control approach, and a low consideration of the individuals' input and efforts, is strongly associated with increased levels of dysfunctional behaviours – both amongst workers and in the leadership complement of the entity. These behaviours have a negative impact on audit quality. Therefore, the importance of good leadership is fairly obvious, and is desperately needed to address the challenges of audit quality (and basic service delivery in the South African local government environment).

Leadership style can have a major influence on the performance of the organisation and the associated audit outcome. This view is supported by Krohmer and Noël (2010) as they investigated both personal and professional ethics as key elements of responsible leadership within the Big Four audit firms in France. Interestingly, their findings revealed that personal ethics are mainly associated with ethical organisational structures and that they also essentially guarantee audit quality. They further alluded to the fact that leading by good example is a favoured way to improve audit outcomes and audit quality (Krohmer & Noël, 2010). Jelic's (2012) research confirmed that the personal ethical skills of a leadership team remains the strongest influence in improving audit quality.

Leadership is viewed as a mechanism to enhance accountability. There is a body of evidence to support this view. Rahimi and Amini (2015) view the relationship between the auditors and the auditee's leadership as the foundation from which to improve financial reporting quality: hence the motivation for this study to consider that there is a relationship between leadership and audit quality in the local government environment. In addition, Velnampy, et al. (2014) examined the characteristics of board members, the leadership structure, the audit committee and the audit quality in the manufacturing companies listed on the Colombo Stock Exchange. Their findings show that there is a significant positive relationship between leadership quality and audit quality. Given this positive relationship between leadership and audit quality, it could be argued that, on the basis of a good quality audit the users of financial statements can confidently assume the business is being well led.

Leadership encompasses a dimension of ethics (Guay, 2013; Lawton & Páez, 2015). In recognition of the significant correlation between ethical leadership and audit quality, Webb (2014) investigated the moderating effect of perceived unethical leadership on reducing audit quality, by examining the behaviour of leadership, and confirmed that the ethics of the leadership has an impact on audit quality. Therefore, leadership characteristics such as integrity and humility are fundamental components of the success of the organisation (Guay, 2013; Lawton & Páez, 2015; Liborius, 2014). Leadership is responsible to improve audit quality through maintaining its organisation's ethical culture and monitoring processes (KPMG, 2014b).

According to Krohmer and Noël (2010:3), leadership quality is a key determinant of audit quality. However, the impact of an authentic leadership together with an ethical organisational culture on the auditor's behaviour showed no impact on leadership and audit quality (Morris, 2014). The study found a significant, statistically negative relationship to exist between a firm's culture and auditor behaviour. As a result, Morris' study suggests that there is a need for the audit firms to commit themselves to applying both the spirit and the letter of the accounting and auditing ethics standards contained in the various internationally recognised codes of professional conduct. Hence, while the auditor's behaviour is also an element of audit quality, it is

likely to be influenced by the leadership behaviour of the audit client. In addition, Lennox (2005) reported that executive turnover is significantly lower for affiliated executive than it is for unaffiliated executives following the issuance of clean audit opinions. This study suggests that companies perceive affiliations to be more valuable after they receive clean audit opinions (Lennox, 2005). It has also been researched that most corporate scandals such as Enron and Worldcom were possible only as a result of poor leadership and inferior audit quality (Chen, et al. 2005). The demise of these companies has now been definitively associated with weak leadership, and made worse by problematic government oversight and under-utilised regulatory regimes (Desmet, et al. 2015; Stein, 2007). Therefore, leadership needs to acknowledge its accountability. Accountability is discussed in the next subsection.

### **4.3 LEADERSHIP ACCOUNTABILITY**

The Auditor General, in its annual assessments, reveals that it is a lack of accountability on the part of leadership that negatively affects public sector audit quality (AGSA, 2011/12). Accountability requires that leadership commands/leads (Thompson, 2013; Said, et al. 2015), which is a crucial step essential to enhance public confidence. According to Agulhas (2012:2), audit quality is best served when the audit enhances public confidence. In the South African local government environment, audit quality has been a subject of a debate for more than two decades of this democratic government's existence. The debate had been fuelled by the repeated failures of leadership to ensure that the local governments achieve clean audit opinions. And the full implementation of the Municipal Finance Management Act in early 2004 has managed to focus the widespread concern about leadership in local government by virtue of its clear statement of what good management and leadership should look like.

This point is also highlighted by Chi, et al. (2013) in their analysis of factors management uses to influence auditors to improve audit quality. They identify that management has a greater influence over the auditors than previously believed, and that this has an effect on audit quality. Cohen and Leventis (2013b:40) also reported that municipal leadership has an effect on audit quality. This is because of audit

delays, which results in non-compliance with legislative frameworks (Cohen & Leventis, 2013b), and put auditors' reputations and performance bonuses at risk. Acknowledging one's accountability has been viewed as a prerequisite of good leadership (Thompson, 2013; Van der Walddt, 2010). Accountability requires efficient and effective leadership which in turn provides confidence and assurance that the management of the local government is behaving honestly and with integrity in regard to their obligations to their citizens. Leadership will always be called upon to address social concerns both within their delegated spheres of responsibility and outside, and be called upon to report on their activities in a transparent and accountable manner (Institute of Directors (IOD), 2009). Said and Jaafar (2014) elucidate that leadership's acceptance of full accountability in the local government sphere ensures the proper use of resources, a clear statement of operating objectives, and also ensures the application of the principles of equality in a fair and open process.

In conformity with society's accountability expectations of leadership, that it answer to the citizens on policies, decisions and actions taken (IFAC, 2014:36), accountability is a requirement in the public sector environment (Abe & Adetoye, 2014:104-108; Said & Jaafar, 2014:298). Accountable leadership in the local government environment brings with it reasonable hope for change and improvement (Giroux & McLelland, 2003; Zhang, 2014; Maddock, 2005). The World Bank (2011) identifies accountability as the quality that strengthens the capacity of organisations and officials to support citizen participation at all levels; that implements communication strategies that ensure easy access to official information; that develops policies and strategies that mandate adoption of feedback mechanisms to respond to the demands of various stakeholders, as well as to report on progress made in implementation of development policies and service delivery. Accountability enhances the functionality of mechanisms which allow citizens to participate in various planning and prioritisation processes such as budgets and community development projects. Therefore, accountability in public sector organisations calls for stewardship on behalf of the public; for leaders to be in the service of the citizens (Podrug, 2011; Waters, 2013; Lindqvist & Mijovski, 2012; Kluvers & Tippett, 2011; Miller & Sardais, 2011; Robb, 2012; IOD, 2009).

According to Kluyers and Tippett (2010:51), accountability enhances leadership's intention and ability to identify the need for and value of information. Accountable leadership also calls for an honest assessment of the value of services being provided, and a willingness to enforce compliance. Such values are required, and embedded in the principles of governance (which are discussed in Chapter 6 of this study), which are manifest as an effective functioning of the audit committee; an effective internal audit function; the effective governance of citizen and stakeholder relationships, and an integrated approach to reporting and disclosure (IOD, 2009).

Said, et al. (2015:225) mention that accountability in the public sector is weakened by poor controls and corruption. The inverse of this statement, as reported in the Parliament of South Africa (Parliament, 2009), is that accountability is enhanced when there is a high level of integrity being displayed by top leadership. The important aspects required of leadership is that it safeguards government against corruption, nepotism, abuse of power and other forms of inappropriate behaviour; improves performances which will foster institutional learning and service delivery, and ensures transparency, responsiveness and answerability to the public. Enhanced qualities of leadership are able to generate public confidence in government, bridge the gap between the governed and the government, and also to enable the public to judge the performance of the government by the government giving account to the public (Parliament, 2009).

It is against this backdrop that leadership and accountability coexist (Nyman, et al. 2005:123). Nonetheless, the AGSA (2011/12) has reported that certain of the Municipal Public Accounts Committees (MPAC) are failing to fulfil their intended oversight roles, while others are totally ineffective. The same accountability characteristics that are expected of national and provincial leadership and oversight committees are expected of these municipal committees when they evaluate the content of annual reports and make recommendations to the municipal council. In addition, they are required to review information relating to responses to recommendations made in previous annual reports, which relate to current in-year reports (such as quarterly, mid-year and annual reports); to examine the in-year financial statements and audit reports of their municipalities, and consider

improvements from previous statements and reports; to evaluate the extent to which the recommendations of the audit committee and the external auditors have been implemented, and to promote good governance, transparency and accountability in the use of municipal resources (AGSA, 2011/12). Should all of these elements be present in the workings of MPACs the audit quality would be significantly enhanced. IFAC (2014:6) views leadership as an important element of the organisation's efforts to improve and better their outcomes. It is also important that the municipal councils constructively engage with, and understand their political responsibilities (Van der Waldt, 2010) in order to assist the municipalities to realise their visions and values. It is against these ideals that local governments attempt to fulfil their Constitutional mandate. This requires them to provide democratic and accountable government for local communities; to ensure the provision of services to communities in a sustainable manner; to promote social and economic development; to promote a safe and healthy environment; and to encourage the involvement of communities and community organisations in the matters of local government (RSA, 1996).

Table 4.1 shows the number of municipalities per province that are managing to deliver on their local government mandates to supply the basic services of water, electricity, sewerage and sanitation and solid waste management. Municipal services are the services expected and experienced by the consumers (Statistics South Africa, 2015).

**Table 4.1: Number of municipalities in each province responsible for and actually providing services under the powers and functions allocated to them**

Province	Number of municipalities	Water		Electricity		Sewerage and sanitation		Solid waste management	
		2012*	2013	2012*	2013	2012*	2013	2012*	2013
Western Cape	30	26	26	26	26	26	26	26	26
Eastern Cape	45	16	16	39	39	16	16	39	39
Northern Cape	32	27	27	27	27	27	27	27	27
Free State	24	20	20	20	20	20	20	20	20
KwaZulu-Natal	61	14	14	51	51	14	14	49	49
North West	23	11	11	19	19	11	11	19	19
Gauteng	12	10	10	10	10	10	10	10	10

Province	Number of municipalities	Water		Electricity		Sewerage and sanitation		Solid waste management	
		2012*	2013	2012*	2013	2012*	2013	2012*	2013
Mpumalanga	21	18	18	18	18	18	18	18	18
Limpopo	30	11	11	25	25	11	11	25	25
South Africa	278	153	153	235	235	153	153	233	233

**Source: Statistics South Africa (2015)**

The South African Local Government Association (SALGA) (2014) recognises the importance of accountability in the effective management of municipalities. In view of the importance of public accountability, SALGA has devoted considerable resources to ensure that the best legislative frameworks are adhered to. Such legislative frameworks include the Constitution of the Republic of South Africa and the MFMA (RSA, 1996; RSA, 2003). However, the complexity of the situation has been compounded by the subdivision of accountability into political, public, managerial, professional and personal accountability domains (Gray & Manson, 2005:49). Therefore, given the breadth of the application of the concept, it should be clear why accountability is seen as such an important element underpinning leadership.

#### **4.4 LEADERSHIP IN THE CONTEXT OF LOCAL GOVERNMENT**

Leadership in the local government arena is about the exercising of formal authority and influence (Siegel, 2010; Giroux & McLelland, 2003; PWC, 2010; Zhang, 2014). It motivates others and also contributes to the achievement of the organisation's goals in its own right (Weil, et al. 2013:1). Hence, Van der Waladt (2010) identifies the leadership in local government as being exercised jointly and severally by the municipal council, executive committees, mayoral committees, the office of the speaker, party whips, and the office of the municipal manager. Figure 4.1 below indicates the key relationships within the municipal leadership. Thus, while Sancino and Castellani (2016) agree that local government leadership is defined according to political settings within the domain of leadership, Bolden, et al. (2003) state that leadership is a complex process and express their serious reservations over the extent to which a single set standard, including qualities and competencies, can ever capture the nature of what makes some leaders successful and others unsuccessfully. In South African local governments both political and administrative



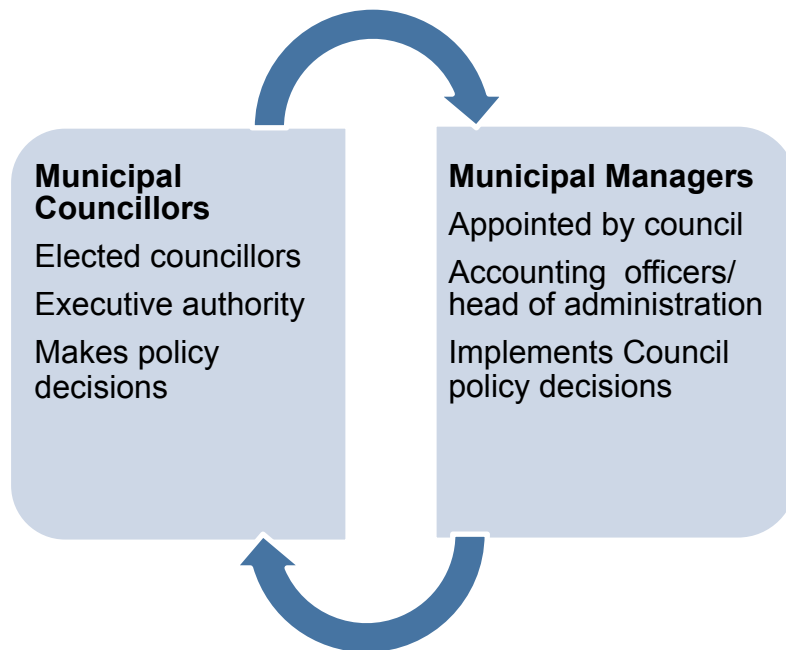
leaders are visible and subject to scrutiny (Koski & Lee, 2014; Giroux & McLelland, 2003; Zhang, 2014), from an administrative perspective (Ricketts & Ricketts, 2011), in their ethical conduct (Matshabaphala, 2014), against the ideal of the office occupied, and in their style of leadership (Sethuraman & Suresh, 2014).

Various authors such as Ricketts and Ricketts (2011), Sethuraman and Suresh (2014), and Koski and Lee (2014), have described leadership as an act of motivation and inspiration to achieve a specific objective. For example, Prewitt, et al. (2011) view the demonstration of leadership as the ability to create a vision and to communicate that vision to others to meet a common goal for an organisation. Although research tends to characterise leadership theory as completely different from management theory (Maslanka, 2004; Sethuraman & Suresh, 2014), leadership is viewed as a critical character trait that brings synergy between leaders and the followers. In the South African local governments, leaders such as municipal mayors, councillors and municipal managers are more visible to the local members of society, and they are also easily scrutinised by anyone who has an interest in the activities of the local government.

Local government plays both critical and contemporary roles in reducing poverty and other sorts of inequality within society. Such roles need leaders to ensure that municipalities deliver basic services such as water, electricity, sanitation and solid waste removal (RSA, 1996). It is a whole lot easier to state that leadership is an important structure of governance than it is to manage and to provide an oversight role in all aspects of service delivery. Of course, a critical oversight role is expected from the Municipal Public Accounts Committee (MPAC). This committee is an oversight structure established by and for local government entities, that is mandated to consider and evaluate the level of assurance required to enhance the credibility and reliability of financial management, compliance with laws and regulations and performance reporting for the municipalities in South Africa (AGSA, 2011/12).

Leadership has been studied from various perspectives. Some researchers discuss leadership from the perspectives of personal behaviour and physical presence (Lussier & Achua, 2007), while others discuss it from the leader-and-follower

perspective (Hughes, et al. 2006) and as a form of management (Thompson, 2013; Daft, 2002). In this subsection leadership is discussed in the context of local government. Leaders are defined by legislative frameworks and government policy documents, and leadership in local government is made up of its governing body (comprising elected and/or appointed office-bearers) (IFAC, 2014:24), as well as its senior management.



**Figure 4.1: provides a brief overview of local government leadership (Source: Adapted from Giroux & McLelland, 2003:206; PWC, 2010:4; Zhang, 2014:362)**

The sections below provide descriptions and explanations of the role of leadership in local governments.

#### **4.4.1 Municipal council**

According to Siegel (2010:141), the local government leadership consists of the municipal council and elected officials. Municipal councillors are the elected political leaders who then delegate the administrative leadership to the municipal manager (Giroux & McLelland, 2003; Zhang, 2014). The MFMA (RSA, 2003) recognises the municipal council as the highest authority in the municipality; the council’s power is strengthened by significant powers of approval and oversight vested by provincial and national government departments. Municipal councillors have a duty to provide

the critical political linkage between the executive mayor, executive committee and the community (Siegal, 2010; Zhang, 2014; RSA, 2003). A good relationship between municipal leadership and the community brings with it hope for effective implementation of policies (Giroux & McLelland, 2003; Zhang, 2014). Sancino and Castellani (2016) provide an analysis of their study of strong leadership in local government in Italy, and concluded that the leadership has a greater influence on their role and responsibilities in governance. Thus, the effectiveness of municipal leadership depends on the councillors' political powers and their abilities to advance policy decisions (Giroux & McLelland, 2003; Zhang, 2014). This means that the political leadership has responsibility to provide political guidance over the policy, budget and financial affairs of the municipality.

#### **4.4.2 Municipal manager**

The role of the municipal manager in leadership is quite a complex and difficult one (Siegal, 2010:169). Municipal managers are serving two masters, one at the political level and the other at the administrative level. Their roles are thus influenced by political dynamics and they are expected to take responsibility for policy implementation (Giroux & McLelland, 2003; Zhang, 2014). At the administrative level, they are expected to exercise leadership over the full range of their control (Siegal, 2010). It is thus a position that requires skills, accountability and leadership (Van Baalen, et al. 2015). As a result, the municipal manager, acting in the capacity of leader, is expected to be able to provide the mayor, councillors and senior administrative officials with the appropriate guidance and advice on finance and budget issues (RSA, 2003). This is an administrative leadership position in which the municipal manager is expected to prepare the annual financial statements for the audit. Hence, it requires an advanced level of skill and knowledge to exercise such a leadership role effectively (IFAC, 2014:24).

According to Nelson and Svava (2015:51), the role of municipal manager has been largely invisible, despite performing an active role in administration (Siegal, 2010). Guda, et al. (2015) argue that leadership plays an important role in improving the quality of financial reporting, which is a vital component of the audit quality (IFAC,

2014). As a result, it is expected of such a leader that he be aware of the role of audit and the effect of its findings and recommendations on the municipality and local citizens (Guda, et al. 2015:8; AGSA, 2011/12).

#### **4.5 STRATEGIC LEADERSHIP**

Strategic leadership in relation to municipalities, needs to ensure that the whole hierarchy is functioning properly and the services are being delivered and rules are being followed (Siegel, 2010:156). As Adair (2011:157) states, “strategy originally meant strategic leadership”. Strategic leadership is concerned with the determination of where the organisation is heading and how to get it there (Quong & Walker, 2010; Agyapong & Boamah, 2013). The concept of strategy is probably one of the most frequently defined terms in business management. Hunger and Wheelen (2014:17) define strategy as “a comprehensive plan” that states how the organisation will achieve its mission and objectives. Strategic leadership is then defined as a process of setting a vision, having energy, encouraging others, mobilising commitment, managing teams, coaching, having integrity, and thinking broadly (Verwey, et al. 2012:7).

According to Verwey, et al. (2012:102), strategic leadership is a process that shows a leaders’ ability to take a strategic, long view on the business’ processes, and is strong on the implementation of the short term goals. Strategic leadership is being recognised as a key element of accountability. Leadership is a challenge in the local government context (Uhl-Bien, et al. 2007:299). It needs adequate and appropriate strategic direction (IFAC, 2014:25). According to Duursema (2013:22), strategic leadership is required at the organisation’s point of interaction with its environment; hence the effectiveness of leadership cannot be measured or captured “merely by the internally oriented effectiveness measure of subordinate job satisfaction”. In a typical organisation, Hunger and Wheelen (2014:17) consider the following aspects of strategy to be in play:

*Organisational strategy* – this describes the overall direction in terms of attitude towards growth and the management of its various business lines.

*Business strategy* – this usually occurs at the business unit level and it emphasizes the improvement of the competitive position of the organisation’s services.

*Functional strategy* – this is an approach taken by functional areas within the business to achieve business objectives and strategies by maximizing resources productively.

In other words, leadership should clarify the strategic direction of the organisation by shaping and building the organisation’s culture (Pearce & Robinson, 2005:343). The overall strategic direction of the organisation is the sum of organisational, business and functional strategies and they are all interactively related in one way or the other. Table 4.2 shows how the leader’s character can enhance the strategic direction of the organisation.

**Table 4.2: Leadership skills**

	<b>Competency</b>	<b>Soft skills</b>	<b>Hard Skills</b>
1	Vision & Path	- Effective communications	- Industry knowledge
	External orientation	- Citizen relationships - Service providers relationships	- Financial skills - Risk management - Knowledge of laws, regulations and compliance
3	Fosters breakthrough thinking	- Collaboration	- Strategy analysis - Critical thinking
4	Developing outstanding talent	- Emotional intelligence	- Performance management
5	Building team commitment	- Leadership - Collaboration - Negotiation - Cultural awareness	- Develop employee reward system - Lead team building and training
6	Propel to action	- Leadership - Change management	- Performance measurement - Project management

**Source: Tarasovich and Lyons (2015:46)**

Maintaining the strategic direction in organisations can be as complex as refining and re-shaping the effective functioning of the organisation, but it is not always so. A brief description of strategic leadership activities is now presented (Bilton & Cummings, 2011:195):

- *Linking* – director connects the actors' ideas to each other and to broader perspectives of the play;
- *Promoting* – this linking framework allows the director to selectively promote specific interpretations;
- *Sussing (getting to the bottom of something)* – the director articulates the interactions and experiments as a coherent vision of the meaning of the play; and
- *Mapping* – the director elaborates his core understanding into a series of instructions.

Yet, the adequate function of leadership seems also to depend upon the role of strategic leadership. Adair (2011:159) makes several recommendations as to the nature of strategic leadership, of which the more important are: giving direction for the organisation as a whole; strategic thinking and strategic planning; making it happen; relating the parts to the whole; building key partnerships and other social relationships; releasing the corporate culture; and choosing and developing leaders for the present and future.

Ricketts and Ricketts (2011:129) argue that leadership should have a purpose and a goal. Thus, in the case of South African local governments, the AGSA invested considerable thought and energy into developing the strategic plans needed to ensure that all municipalities receive clean audits by the end of the 2014 financial reporting cycle. Thus, the journey towards developing local governments' strategic leadership became a fundamental component of local government. The journey has been motivated and authorised by the Constitution (RSA, 1996), and given added impetus through the introduction of the Local Government Turnaround Strategy in December 2009. This 2009 Turnaround Strategy document outlined a ten (10) point plan to translate government strategy into action.

1. Municipalities are required to improve the quantity and quality of basic services for all people in terms of water, sanitation, electricity, waste management, roads and disaster management;
2. they must enhance the municipal contribution to job creation and sustainable livelihoods through local economic development and by utilising cooperatives in every ward;
3. democracy must be deepened through a redefined ward committee system that will be responsive to the will of the people;
4. municipalities must develop and implement reliable and credible integrated development plans;
5. they must build and strengthen their administrative, institutional and financial capabilities;
6. they must create a single point coordination, support, monitoring and intervention in order to deal with uncoordinated interactions by other spheres of government with municipalities, including unfunded mandates;
7. municipalities must root out corruption, nepotism and maladministration in the system of local government;
8. municipalities must develop a coherent and cohesive system of governance and a more equitable intergovernmental fiscal system;
9. they must collectively, develop and strengthen a stable system of municipalities; and
10. the institutional integrity of municipalities must be restored (COGTA, 2009).

#### **4.6 ETHICAL LEADERSHIP**

Previous research has investigated ethical leadership and validated the assertion that it brings hope to the followers and that it positively affects the organisational outcomes (Yuki, et al. 2013; Eisenbeiss & Knippenberg, 2015; Kacmar, et al. 2013; Lawton & Páez, 2015). According to Kacmar, et al. (2013), leaders are considered to be ethical based on their norms and values they uphold. These values require that leadership demonstrates loyalty and trust even when they are not being observed (Yuki, et al. 2013:41).

According to Disolaone (2012:49), ethical behaviours are needed in order to place local governments under greater scrutiny, and thus to induce organisations to become more socially responsible and accountable. Hence, Lawton and Páez (2015) identify integrity and authenticity as virtuous characteristics that are able to ensure accountability. As has been widely observed, ethical practices increase the society's trust in its leadership, which in turn enriches society. Thus, ethics in daily practice underlie and guarantee a leadership that is fair to all (Eisenbeiss & Knippenberg, 2015; Kacmar, et al. 2013). Ethically motivated leaders are needed in all communities, organisations and especially governments (Ricketts & Ricketts, 2011:4).

The concept of ethical leadership has been discussed in the King III Report (IOD, 2009) which contains guidelines as to what the ethical behaviour and conduct of business leaders should demonstrate. The King III Report, despite being conceived as a private business sector guidance document, describes many principles of good governance that are essential to the success of the public sector's legislative framework. These include the principles of accountability, fairness, transparency and responsibility (IOD, 2009). The principles of good governance, including ethical leadership, contribute positively to the success and effective performance of organisations, as Shin, et al. (2015), and Wu, et al. (2015) affirm. Thus, there is a clear relationship between good corporate governance and ethical leadership (Ho, et al. 2015; Wu, et al. 2015).

Leadership principles are just the same, whether used in private sector organisations or the public sector. Thus, the ethical intelligence of a leader depends on moral awareness, and is the reflection of their skills and moral imagination (Jelic, 2012). In addition to recognising the effect of the ethical positioning of leadership, Morris (2014) hypothesised that when leadership is perceived to be authentic, there is a positive association with the perception that a firm's culture is ethical. The results show that there is a significant positive correlation between authentic leadership and the firm's culture of ethical behaviour. Therefore, the results suggest that a leader must always demonstrate a moral self-awareness in order to provide effective leadership (Morris, 2014).



Against this backdrop, maladministration in South African local governments has opened the flood gates to unethical leadership (Madonsela, 2013). Ethics is not only about honesty and integrity (IOD, 2009). In a survey of public sector ethics conducted in the United States of America (USA) in 2007 the ethics awareness and adherence in the public sector was investigated. Results revealed that local governments in particular are unlikely to know about their ethics risks. The surveyed local governments experience the lowest levels of clean audit reporting (67 percent), the highest pressure to commit misconduct (16 percent of respondents acknowledged being pressured), and the highest levels of retaliation against those employees who do report misconduct (20 percent confirmed retaliation) (Ethics Resource Center, 2008). As a counter to this, an ethical leadership could ensure that there is trust in the organisation's systems, that management supports and encourages full commitment to ethical actions from everyone, and that they do the right thing by living up to the leader's ethical expectations.

#### **4.7 SUMMARY OF THE CHAPTER**

This chapter provided a review of literature on leadership and audit outcomes. Several attempts were made to answer the research question linked to this chapter – *How does leadership affect clean audit outcomes?* Published research discusses and answers this question: at its simplest, ethical and honest leadership does improve outcomes. However, the literature also reveals that the qualities manifest by municipal councillors and municipal managers, as components of leadership in the local government environment, have an important role to play in the quality of audit outcomes. The review further identified that the problem faced by leadership in local government structures lies within their complement of competencies and acceptance of personal accountability. Despite clear guidelines prescribing both political and administrative leadership responsibilities, South African municipalities in particular are still facing debilitating challenges arising from the present qualities of their leadership, a situation which makes local government structures vulnerable to pressures of corruption and the condoning of non-adherence to laws and regulations. The next chapter presents a literature review of research focused on financial management and audit outcomes.

## **CHAPTER 5**

### **MUNICIPAL FINANCIAL MANAGEMENT AND AUDIT OUTCOME**

#### **5.1 INTRODUCTION**

This chapter reviews existing literature on municipal financial management and audit quality, and in particular examines the effect of financial management on the achievement of the so-called 'clean audit' outcome. It does so by presenting the concept of financial management, an overview of financial management practice, financial management in the context of local government, and the factors specific to financial management in the South African public sector environment. The chapter concludes with a brief summary of the issues discussed.

#### **5.2 FINANCIAL MANAGEMENT AND AUDIT OUTCOME**

This subsection discusses the concept of financial management and the link between financial management and audit outcome.

##### **5.2.1 Concept of financial management**

Financial management can be defined as the management of the finances of an organisation in order to achieve the financial objectives of the organisation (Brigham & Houston, 2012) and it affects all components in the organisation (Ciuhureanu, et al. 2009). Financial management is a concept derived from the business concepts of finance and management. These two concepts are at the centre of any business operation as they are essential to the business organisation's ability to run its operations efficiently and effectively. It would also be fair to say that, in order to have all business operations running smoothly, the audit (as part of financial management) is a critical function to evaluate the information provided by management to ensure that there is a proper use of resources in the organisation. Hence, a successfully audited evaluation system allows management to determine how the organisation's resources are contributing to the achievement of organisational objectives (World Bank, 1998:112).

Financial management is concerned with investment decisions (Firer, et al. 2009). Thus, the responsibility to plan, budget and invest is associated with financial managers. In addition, Firer, et al. (2009) recognise that in order for the financial manager to make better decisions, financial goals need to be congruent with those of the business entity. Thus, financial management must address issues such as investment survival; avoidance of financial distress and bankruptcy; competitiveness; maximisation of investment returns; minimisation of costs; maximisation of profits, and the maintenance of a steady growth in profits. Financial management can contribute to and participate in almost all activities within an organisation. However, the function is most significantly involved in coordinating changes in financial planning (Singh, 2007); implementation of internal controls (COSO, 1992); performance of the internal audit function (Institute of Internal Auditors (IIA), 2012); audit committees (Institute of Directors (IOD), 2009), and financial reporting in compliance with the terms of the preferred professional reporting standards (IFAC, 2014). Therefore, the financial manager is required to be able to make the right business decisions in terms of asset and liability management, revenue, expenditure and budgeting. In the public sector, financial management focuses on the prioritisation of demands on and use of scarce resources, on ensuring effective 'stewardship' over public money and assets, and on achieving value-for-money in procurement in efforts to meet the objectives of Government; i.e., they are (or should be) concerned with the rendering of the best possible services to their customers. And finally, this must all be done transparently and in terms of all relevant legislation.

The fact is that financial management is an important element of the overall business function. Johnson (1991) records that the merging of finance and management into financial management happened gradually between the early 1800s to the early 1920s. This was driven by the need to deal with changes to the realities of economics, from a local market setting into a global business setting. In addition, during this period businesses began to internalise various economic activities (Johnson, 1991). Subsequently, at the end of World War II, there were several developments in the fields of economics and finances (Shapiro, 2006), that, for whatever reasons, saw developments that resulted in economics and finance becoming key to the management of funds (thus, bringing finance and management together into a single discipline), and which is now recognised as financial

management (Johnson, 1991). As one might have anticipated in those early years, internationally orientated businesses were already undergoing a revolution (Shapiro, 2006). Johnson (1991) further records that in the nineteenth and twentieth centuries business organisations had already begun to invest and participate in overseas mining ventures, manufacturing, transportation and distribution and had also decided to internalise numerous opportunities for the market exchange.

The development of the theory of financial management, Shapiro (2006) posits, grew out of the fact that, for thousands of years there have been transfers of goods and services across national borders and between distant communities. Johnson (1991) theorises that the formal development of financial management took place during the industrial revolution, starting in the early 1800s. He is also of the opinion that it was a reflection of efforts by the business organisations to accelerate their access to market price information (and the economic advantages that brings). However, Johnson (1991) also posits that financial management may have very well been in operation before World War I, as a means primarily of stimulating market prices. This outward-looking aspect of financial management essentially disappeared when business organisations began to look inwards for ways to improve financial viability and productive efficiencies, and begin to manage transactions at the levels of workers and business units.

The origin and evolution of the concept financial management is a fragmented tale that reflects the “zig zag” course of human history. However, the first modern academic research into the history of the concept of financial management appears to have been published by Victor L. Andrews in 1981 in *Financial Management* – the periodical he was editing at the time. His research demonstrates that financial management was already associated with the professional associations, irrespective of the nature of employment enjoyed by the practitioners (Andrews, 1981). Ultimately, despite his best efforts, by 1981 Victor L. Andrews admitted that his survey of available archival information about the history of financial management left him certain only that there was no clear line of development or cause-effect relationships explaining the development of financial management. Interestingly, the editor remarks in his editorial column that:

*“there was little, if anything, within the editorial realm of Financial Management's early history wholly without some precedent or parallel. It is accurate to say, however, that the combination of ends sought and means elected by the editors of financial management was comparatively rare and perhaps even unique”.* The editor concluded that *“it is discoverable, I think, with simple questions as to what in fact is the financial function, how is it administered in business, and by whom?”* (Andrews, 1981:114-115).

As a result of (or despite) the efforts to formalise the concept of financial management, information about finance has continued to develop and change. Today, the field of finance influences the development of financial management, which currently focuses on the allocation of funds to current assets and fixed assets in support of the business' objectives (Block, et al. 2011). One of the most widely accepted general theories of financial management is that of Correia, et al. (2007); their publications reflect on the theories on finances, accounting and economics. For example, these writers (Correia, et al. 2007) characterise financial management as a discipline which relies on the aspects of both economics and accounting for its framework and authority. Thus, the intellectual driving forces of effective financial managers are derived from their knowledge of economic indicators including the gold price, foreign currency exchange rates, the inflation rate and the current interest rates (Correia, et al. 2007), and financial managers are thus well-equipped to make decisions on how to finance the organisations (Brigham & Ehrhardt, 2014).

Accounting is a subject that deals with financial figures and the analysis of historical information (Singh, 2007:vii). Killian (2014:34) views accounting as a process which informs business decisions through allocation of resources and mediating relationships in different sections of the organisations. According to Singh (2007:vii), financial management takes the accounting information and processes it for financial decisions, investment decisions and dividend decisions. Therefore, financial management can be viewed as the connector between economics and accounting. This is because accounting is concerned with recording, classifying and summarising transactions (Simon, et al. 2011:16), while management is concerned about doing something more with that information. Authors such as Block, et al. (2011) acknowledge that accounting provides financial managers with the raw material for

the application of the International Financial Reporting Standards and its interpretations so as to assure investors about the financial status of the organisations. Separating the *two strands* of thought:

- **Financial management and economics:** economics provides a structure for decision making in the areas of risk analysis, and pricing theory through analysing supply and demand relationships. In other words, an understanding of economic factors such as gross domestic product (GDP), industrial production, unemployment, inflation, interest rates and taxes enhance the financial manager's effectiveness in decision making (Block, et al. 2011).
- **Financial management and accounting:** Block, et al. (2011) identify that accounting provides financial data through financial statements. The financial manager needs to interpret and use these financial statements when allocating the financial resources of the organisation, in order to generate maximum returns for the business.

Many principles of financial management emanate from the United States of America, the United Kingdom, France and Germany (Correia, et al. 2007). Nonetheless, while the history and development of financial management still requires further research (as there are discrepancies and conflicts in the records of the development of the field of financial management) it is widely recognised that financial management underpins, and has in fact become the lifeblood and unifying element of business activities (Paramasivan & Subramanian, 2012; Correia, et al. 2007). The same holds true in local government financial management: financial management is designed to provide an effective and efficient way of managing finances in order to implement local government service delivery strategy (Hill, 2009:14).

Despite the number of decades the debate has raged about the definition of the concept of financial management and its development, there is still no clear evidence to support a linear historical development of financial management. Writers such as Johnson (1991) have some doubts that financial accounting did provide the first sophisticated financial management information. Brigham and Houston (2012:2)

have built their theory of financial management on the assertions made by Adam Smith in 1776. Smith maintained that

*“a firm’s principal goal should be to maximize the wealth of its stockholders, which means maximizing the value of its stock; free enterprise is still the best economic system for the country as a whole and under the free enterprise framework, companies develop products and services that people want and that benefit society; and however, some constraints are needed – firms should not be allowed to pollute the air and water, to engage in unfair employment practices, or to create monopolies that exploit consumers.”*

Financial management is thus intertwined with various other business disciplines (Block, et al. 2011; Brigham & Houston, 2012; Correia, et al. 2007), and Table 5.1 shows the different activities with which financial management interacts.

**Table 5.1: Business management activities in which accounting, economics and financial management collaborate**

No.	Activity	Accounting	Financial management	Economics
1	Budgeting	√	√	√
2	Annual financial statements	√		
3	Annual reports	√	√	√
4	Revenues	√	√	√
5	Expenditure management	√	√	√
6	Debt management	√	√	√
7	Cash management	√	√	√
8	Investments		√	√

**Source: Researcher’s own illustration**

Since the sequence of events and flows of information that have led to the development of financial management is unknown (Andrews, 1981), the above table is a useful illustration of the functional relationship between the elements that are conventionally accepted as part of financial management. In each of the above activities, financial management can be linked either to accounting or economics.

Hence, financial management's participation in the preparation of annual financial statements is assisted by input from the accounting area, and when investments are analysed and interpreted at the financial management level pertinent input is provided by the economics specialists. According to Correia, et al. (2007) organisations have been employing financial management principles for centuries, and in general, financial management relies heavily on economics and accounting to complete the management picture. Despite the widespread use of the term 'financial management', there has been only limited consensus on how it should be defined. Singh (2007) defines financial management as the acquisition of funds at optimum cost and their utilisation with minimum financial risk. The definition has been augmented to address the financial planning, analysis and control aspects of business, so as to achieve optimal performance of business operations. Thus, when the finances and other resources are managed effectively in the public service arena, the need for public service delivery protests is minimised.

**Public sector financial management** – The need for better public sector financial management has been recognised as an important component of improving the quality of public service delivery (ACCA, 2010:2). Improving public sector financial management requires strong administrative leadership and robust governance structures, based on a clear understanding of the legal framework of public sector financial management. Financial management is concerned with management of funds (Singh, 2007:188). According to the Chartered Institute of Public Finance and Accountancy (CIPFA) (2010:4) public financial management can be defined as *“the system by which financial management resources are planned, directed and controlled to enable and influence the efficient and effective delivery of public service goals”*. Financial management is concerned with the achievement of organisational objectives (IFAC, 2015). The essence of financial management is universally applicable to local government, regardless of size, type and location (Eze & Harrison, 2013). Financial management is one of the business disciplines that interrelates most flexibly with all other business activities. The financial management concept has thus been seen at the centre of every business activity. Therefore, the effectiveness of financial management requires that people determine the information needs, processes and systems required to collect the right data, and then to turn such data into information that is useful (IFAC, 2015). Financial



management is present in every business environment (Correia, et al. 2007). According to Paramasivan and Subramanian (2012), effective financial management is the life blood of any business organisation. Hence, as an essential part of the development process, the effectiveness of the performance of the financial management function is reflected in the smooth running of the business, as it provides complete coordination between the efforts of the various business functions (such as purchasing, marketing, and production); it helps managers to evaluate the profitability of the operational activities of the organisation; it helps managers at all level in decision making; it enhances the credit worthiness of the business, and helps determine the financial soundness of the organisation (Periasamy, 2009).

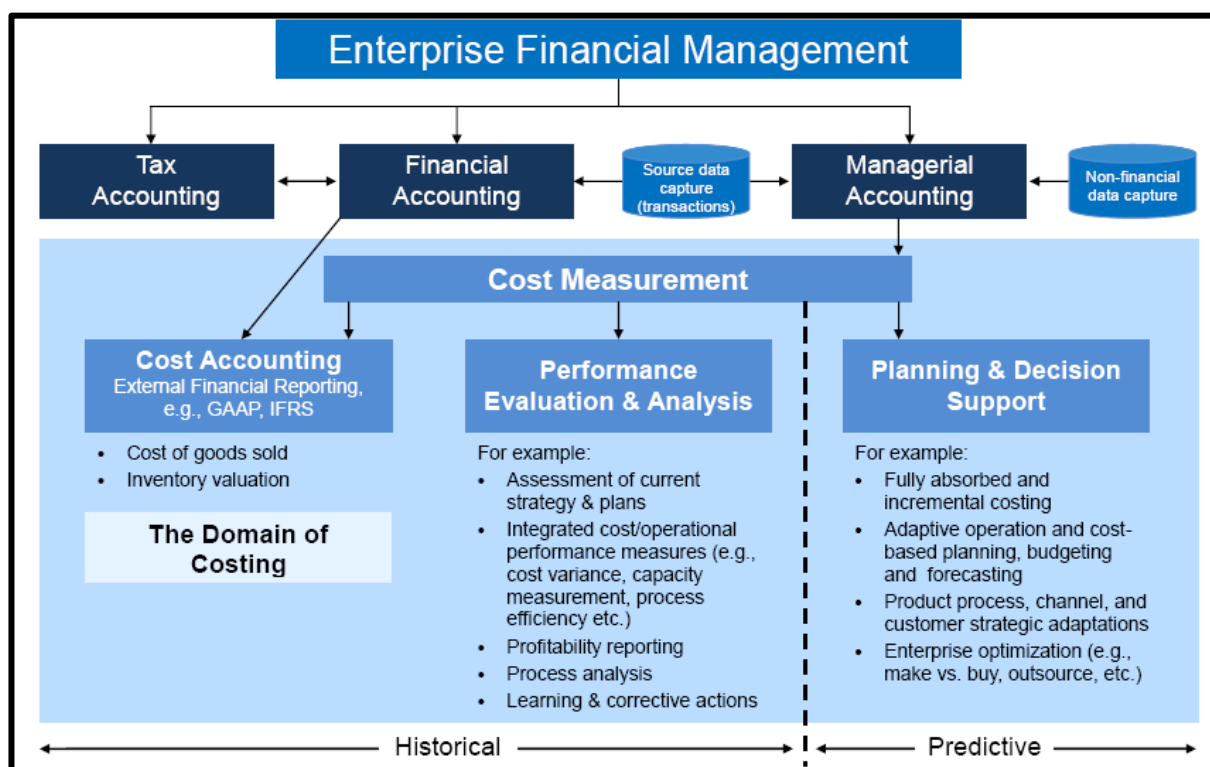
IFAC and CIPFA (2014:30) state that a strong financial management function ensures that public money is safeguarded at all times and used appropriately, economically, efficiently, and effectively. According to Singh (2007:188), financial management involves acquisition of funds at optimum cost and their utilization with minimum financial risk. The term 'financial management' is connected with the theory concerning the finances of the organisation. However, Brigham and Houston (2012) have noted that in the organisation, the financial management function can be divided into three categories. Understanding these categories gives depth of understanding to the meaning of financial management. **First: corporate finance** focuses on decisions relating to the types of assets the organisation acquires, how to raise the capital needed to buy the assets, and how to run the organisation in order to maximise profits. **Second: capital markets** are the markets where interest rates, along with shares and bond prices, are determined. **Third: investments** the term relates to decisions concerning shares and bonds, which include the activities of security analysis (to find a rational value for shares and bonds); portfolio theory (dealing with the best way to structure portfolios of shares and bonds), and market analysis (which deals with trends in the shares and bond markets and attempts to answer the question: are the prices of these assets too high or too low (Brigham & Houston, 2012).

Improving public financial management is not without difficulties (Association of Certified Accountants (ACCA), 2010:4). Hence, IFAC and CIPFA (2014:30) have

suggested that public sector financial management should at least consist of the following activities:

- “funding and allocation for the delivery of public services, including establishing financial objectives, policies and strategies, capital planning and budgeting, raising finances, tax planning, and managing working capital, cash flow, and financial risk;
- performance management through developing and implementing a financial strategy, cost determination, budgeting, forecasting, and financial control; and
- provision, analysis, and interpretation of financial and non-financial information to the governing body and managers; supporting them in understanding the entity’s financial health and progress in delivering financial objectives; and providing the information and analysis needed for organizational objective setting, strategy formulation, execution, and control”.

Municipal services should be approached with a cost recovery mind-set, rather than trying to produce extra revenues (Venkateswaran, 2014:145). According to Venkateswaran (2014:145), “cost accounting and fund accounting are more sophisticated systems that provide more specific information on key activity areas and functions and eventually on local government effectiveness overall”. The main types of accounting include financial accounting, cost accounting, managerial accounting, and tax accounting. *Cost measurement and accounting* provides key information for managers that helps them to make operational decisions and to analyse operational efficiency (Venkateswaran, 2014). This is because, with an enterprise-wide financial management system in place, service delivery is managed and measured while costs are monitored. Figure 5.1 below illustrates how the cost accounting function could influence the entire financial management process as it provides immediate information regarding tax accounting, financial accounting and management accounting. Hence the cost accounting information is used by the management at all levels of the organisation. Cost measurement supports all three elements of an enterprise’s financial management as illustrated in Figure 5.1. This support is important as it enables financial managers to identify, interpret, measure and present information for costing purposes (IFAC, 2009:10).



**Figure 5.1: An enterprise financial management (Source: IFAC, 2009:8)**

**Challenges faced by public sector financial management:** Public sector challenges include local and national politics, legislation, social phenomena and local and regional economic issues. ACCA (2010:4), in their study entitled “Improving public sector financial management in developing countries and emerging economies” acknowledges that:

- Public sector financial management reforms have lagged behind those in the private sector.
- There are skills deficits and staff retention issues.
- Losses and waste is rife in the public sector.
- There is a critical need to improve accountability and transparency over public spending on behalf of the general public and tax payer.
- Resource allocation is weak.
- There are serious deficiencies in financial data and budget reporting.
- Accounting and auditing systems are antiquated.
- There is a need to comply with internationally accepted accounting practice standards.

- There is a need to strengthen governance particularly in developing countries.
- There is a need to improve efficiencies and effectiveness in service delivery.
- The legislative framework is weak.

The local government turnaround strategy set forth by the Department of Cooperative Governance and Traditional Affairs (COGTA) in 2009 has played a role in ensuring that the municipalities are becoming accountable and responsible for the management of finances. But there are still some bleak elements in the area of accountability that continue to be reported in the AGSA's reports. These include a lack of capacity in financial management and an inability to account convincingly for the use of public funds and resources (AGSA, 2011/12). According to Deloitte (2012), the poor state of financial management contributes significantly to the current service delivery backlogs, estimated at 19.3% in water supply connections, 32.6% in access to sanitation, 27.3% in access to electricity and 40.1% in access to refuse removal. That a realistic turnaround strategy depends on having good administrative and political leaders to implement the local government intentions is axiomatic, and South Africa's shortfalls are made obvious by these numbers.

**Financial management system in the South African local government:** Before the 1994 democratic elections, the development of local government financial management is inextricable from the apartheid system of government, which enforced racially divided local areas of municipalities. Not only was race a determining element, the political systems, administration and financial management systems were also different. Over the immediate past decade the South African local government landscape has undergone a major financial legislative transformation, which started with the introduction of the Municipal Financial Management Act of 2003. Under this Act a new and uniform financial management instrument became applicable to all municipalities in South Africa. This new financial management instrument is intended to enhance governance, accountability and transparency in the management of municipal finances and resources. In addition, the changes to the system of local government have brought huge relief to many municipal governments through grants from provincial and national governments, made necessary by the fact that the majority of these previously "black municipalities"

cannot generate sufficient revenue from their own residents and local economies to sustain an efficient and effective service delivery programme. Historically, the rural municipalities were geographically distant from local businesses and retail outlets, which meant that they were unable to generate a meaningful income in support of service delivery objectives. The urban municipalities, whether categorised as “urban black” or “urban white”, were (and still are) able to generate local revenue to fund their own service delivery objectives. However, the municipalities that are predominantly rural, and with underdeveloped economies still generate far less revenue from retail stores, industries and residential property rates than do the so-called “white” municipalities (Republic of South Africa, Green Paper on Local Government, 1997).

Financial management systems in use in South African municipalities have been subjected to multiple changes and transformations in the last 20 years. Initially, financial statements were prepared according to the Generally Accepted Municipal Accounting Practice (GAMAP) standards, a British Colonial legacy (Scott, 2008:2) in turn was derived from the Generally Accepted Accounting Practice (GAAP) standards. However, in 1997 the need for a modern approach to finance necessitated substantial updates to and changes in the standards, which resulted in GAMAP being replaced by the Generally Recognised Accounting Practice (GRAP) standards (National Treasury, 2005). The enthusiasm for development and financial management reform in local government that was becoming apparent, and was supported by the Constitution of the Republic of South Africa requires the National Treasury to prescribe measures to ensure both transparency and expenditure control in each sphere of government. National Treasury believed that by introducing the more widely recognised and modern Generally Recognised Accounting Practice (GRAP) standards, uniform expenditure classifications and uniform treasury norms and standards would be achievable, and thus fulfil the requirements of section 216(1)(a) of the Constitution (RSA, 1996). Thereafter, the GRAP standards were introduced to guide the municipalities in the preparation of their financial statements.

Currently, all the municipalities in South Africa are now using the uniform structure of financial reporting according to GRAP. However, the implementation of the GRAP standards underwent a phased in implementation, with the National Treasury

requiring the first 50 high capacity municipalities to implement the standards for GRAP by the financial year ending 30 June 2006. Thereafter the 107 medium and 127 low capacity municipalities were required to implement the standards for GRAP by the financial years ending 30 June 2007 and 30 June 2008 respectively (National Treasury, 2005). According to Simson, Sharma and Aziz (2011), financial reporting is directly related to the annual financial statements which form the basis of the audit or review of government's performance. Hence, Treasury's requirements regarding financial statements are intended to achieve the following:

- to bring about uniformity in financial reporting, and to ensure consistency and comparability in the data published by the municipalities and other government organizations;
- the implementation of the standards must provide a generally understood and accepted measure of the responses to the phenomena being monitored; and
- adoption of the standards should significantly reduce the amount of manipulation required by the reported numbers than would otherwise be likely to occur in the absence of the standards (Singh, 2007).

A uniform format to and standard of municipal financial reporting is not a new ideal, nor is its implementation unique to South Africa. Other countries, such as the United States of America, use the same formats for municipal financial reporting that are employed in South Africa (Venkateswaran, 2014:139). Financial management includes managing all direct and indirect functions and activities involved in the flow and mobilisation of revenue; it also involves the allocation of funds to various activities, and recording expenditure and accounting for spending of funds (Simon, et al. 2011). In the South African local government environment, the evolution of democratic government has necessitated the use of financial management instruments and policies to deal more effectively with the finance of local governments. This democracy-inspired financial management instrument is called the Municipal Financial Management Act (MFMA), which has become a crucial guide and tool for local governments in planning, organising, directing and controlling their financial activities. What, precisely, is so important about financial management systems is their abilities to enable management to prevent, discover, and facilitate

the processes required to identify fraud and corruption events (Fjeldstad, et al. 2004). In local government, financial management focuses on the prioritisation and use of scarce resources, on ensuring effective 'stewardship' over public money and assets, and on achieving value-for-money in meeting the objectives of rendering the best possible services to local communities (National Treasury, 2000).

The Municipal Finance Management Act (MFMA) was enacted on 13 February 2004 and introduced an integrated set of financial instrument to regulate and manage the affairs of local governments in South Africa. Its purpose is to enable, guide and secure sound and sustainable management practices in the sphere of local government, and other, associated institutions; to establish treasury norms and standards for the sphere of local government; and to provide guidelines for addressing the following matters:

- Ensuring transparency and accountability, and appropriate lines of responsibility in the fiscal and financial affairs of municipalities and municipal entities;
- the management of municipalities' revenues, expenditures, assets and liabilities and the handling of their financial dealings;
- budgets and financial planning processes, and the coordination of those processes with the processes of other organs of state in other spheres of government;
- borrowing;
- the handling of financial problems in municipalities; and
- supply chain management and other financial matters (RSA, 2003).

Therefore, the importance of financial management in the local government sphere is that it is intended to enable "the local government to plan, mobilize and use financial resources in an efficient and effective manner as well as fulfil its obligation to be accountable to its citizens" (Venkateswaran, 2014:93). Effective financial management in every business organisation helps to ensure that there are sound financial systems and processes in place throughout that entity. In addition, effective management brings out proper accountability in the management of funds. It is a crucial element of effective management, that through its transparent budgeting

processes and effective management of revenue, expenditure, assets and liabilities, responsive and responsible government is achievable (Venkateswaran, 2014:93).

### **5.2.2 Link between financial management and audit outcomes**

Literature reviews show that audit outcomes reflect the effectiveness of financial management (IFAC, 2014; Rahimi & Amini, 2015; Neri & Russo, 2014; Svanberg & Ohman, 2013). Modern financial management could better be described as the sum of technical competencies, skills, accountability and transparency (Eze & Harrison, 2013). Unfortunately, 'audit quality' and 'quality of audit' are two different concepts that are too easily seen as interchangeable: they are not the same. Prior research has identified several measures that may influence the audit quality: these include the audit fee, size of audit team, auditors' independence, auditor tenure, professional scepticism and many more (IFAC, 2014; Rahimi & Amini, 2015; Neri & Russo, 2014; Svanberg & Ohman, 2013). Thus, when an external audit is performed in full compliance with its technical, legal and moral responsibilities and fulfils its objective, the users of the audited financial statements become confident that the auditor has worked to a suitable standard and that a 'quality audit' has been performed (i.e., the outcome can be trusted). Likewise, the output (audit opinion), audit process (auditors' understanding of the audit environment) and input (auditor's perception) are all components and measurements of audit quality (IFAC, 2014). With all these processes being successfully completed, Rahimi and Amini (2015:101) explain, the 'audit quality' becomes the sum of the quality of the audit and the audit process. Then, the quality of audit is about the checklist – by the diligence devoted to checking compliance with the applicable standards (Neri & Russo, 2014). Therefore, on successful completion of an audit, financial management's offer of solutions for investment decisions, financing decisions and dividend decisions is all the more compelling (Ciuhureanu, et al. 2009). Although no studies were found that established a direct relationship between financial management and the audit quality, this study finds it valuable to consider the relationship between financial reporting and internal financial controls, as a part of financial management.

There have been two reviews of the effect of audit quality on financial performance (Ziaee, 2014; Darabi, et al. 2012). These reviews sought to identify and synthesise



empirical research into audit quality in relationship with financial management, albeit using slightly different approaches in which to present the key findings. These studies' findings show that the effects of financial management on audit quality occur at the level of the review of the quality of financial reporting. Thus, the quality of financial management, as a day-to-day process of managing the finances of the organisations, can affect the audit quality and the quality of financial reporting. Therefore, audit quality plays an important role to make financial statements reliable (Alrshah, 2015). Again, audit quality as an outcome depends on the quality of the input – that financial management's effectiveness influences.

Supporting the above views, Ziaee (2014) investigated the relationship between audit quality and financial management quality. His findings revealed a positive relationship to exist in that audit quality and the quality of financial reporting play an important role in increasing the public's confidence in that organisation. Of course, one of the benefits of having quality financial reporting is that the provision of quality financial information increases the confidence of the investors, creditors and other users of this information in their decisions relating to investments and the granting of credit (Darabi, et al. 2012). Hence, as Farouk and Hassan (2014:1) argue: "if the audit is used to improve financial performance, there must be credibility and reliability in the audit of financial statements".

Kaklar, et al. (2012) concluded that there is no significant relationship between audit firm size and financial reporting quality, thus eliminating one of the influences that were once presumed to affect the decision-making processes of financial information users and lenders in their investments decisions.

Since financial management involves a variety of tools when managing the finances of the organisations, Chen, et al. (2013) used quality, size and financial performance to determine the relationship with audit quality. They concluded that there is a positive relationship and that audit quality does improve financial performance. According to Farouk and Hassan (2014:2), the effect of audit quality on financial management and performance is realised when an independent audit improves confidence in the financial reporting. Thus, the results of the study by Farouk and Hassan (2014) confirm that a positive relationship exists between audit quality and

financial performance, and that a quality audit outcome positively affirms the quality of a firm making substantial net profit.

Despite the fact that the quality of financial reporting influences the relationship between financial management and audit quality, the quality of internal control is also a factor that impacts the relationship between financial management and audit quality (De Simone, et al. 2015; Rae & Subramaniam, 2008). The quality of audit is a process used by the auditors to assess and verify the quality of financial management and its performance (Furouk & Hassan, 2014). Thus, the improvement of internal control enhances the audit quality (De Simone, et al. 2015), which is an important element of financial reporting (Ziaee, 2014). Similarly, Rae and Subramaniam (2008) also examined the influence of the quality of internal control procedures and concluded that the quality of internal control is significantly and positively related to the corporate ethical environment, risk management and internal audit activities. Their study further suggests that the better the audit procedures are the better the quality of internal control, and that the auditors should pay more attention to all organisational policies and procedures. Thus, the importance of internal control in financial reporting has been effectively associated with audit quality and financial performance (Feng, et al. 2009).

Doyle, et al. (2007) examined the determinants of 'weakness in internal control' for 779 firms in which audit disclosed 'material weakness over financial reporting'. Their findings reveal that these firms tend to be smaller and their weakness is a result of internal control challenges. However, as Ashbaugh-Skaife, et al. (2007) note, the suspected internal control deficiencies are more likely to be audited and reported in the financial statements than in the case of firms that are perceived to have robust internal controls. Leone (2007) investigated the factors that relate to internal control disclosures, and also concluded that the internal control deficiencies must be presented, detected and also disclosed. Since the literature review presents no direct association between financial management and audit quality, it was nevertheless deemed appropriate to discuss the main elements of financial management and audit quality next, being the financial reporting quality, and the financial internal control quality.

### **5.2.2.1 Financial reporting quality**

Essentially, what brings audit and financial management together is the financial statements. Thus, the audit team evaluates the internal controls and the assertions made by the financial management function to the auditor, as presented in the financial statements. According to Riel and Tano (2014:7), financial reporting quality is threatened by manipulation from management. Preparation of reliable financial statements is one of the competencies of financial management. But, the role of the financial management function differs significantly depending on the nature and complexity of the organisation employing it. The role of financial management and accounting in financial reporting have been investigated by Georgescu, et al. (2006). Their finding shows that effective financial management is likely to contribute positively to the improvement of the quality of financial statements and thus audit quality. Quality financial statements enhance the audit quality by lowering the risk of undiscovered non-compliance with applicable frameworks. PWC (2015) identifies quality in the financial reporting process as a means to demonstration of compliance with accounting and auditing standards, and also because this then shows a deep understanding of the financial environment in which the client operates. Financial statements are part and parcel of a formal process that businesses use to communicate accountability to their stakeholders. Accordingly, the qualitative characteristics of financial statements are equally important components of financial reporting quality (Agyei-Mensah, 2013). These qualitative characteristics of financial reporting include relevance and faithful representation, comparability, timeliness, verifiability and understandability (IASB, 2010).

Agyei-Mensah (2013) conducted a study of the adoption of International Financial Reporting Standards (IFRS) and its impact on the quality of financial statement disclosures. His findings indicate that auditors are significantly associated with the quality of financial statements. Meanwhile, Lobo and Zhao (2013) investigated the relationship between audit effort and financial statement misstatements, and found no relationship between audit effort and annual reports. However, Martinez-Ferrero, et al. (2015) report that there is a positive relationship between the quality of financial information and disclosure. Financial statements are prepared on a going concern basis. Sundgren and Svanstrom (2014) studied the association between the number

of audit assignments and the likelihood of mis-reading the auditee's going concern status, and found that there is no relationship between going concern status and audit quality. Therefore, it is fair to say that the quality of the financial statements is the product of financial management's efforts alone (Mande & Son, 2012), and hence, that financial management's ability to fulfil its role affects all components of the organisation (Ciuhureanu, et al. 2009).

#### **5.2.2.2 Internal financial control quality**

Financial management cannot be isolated from internal control. Internal financial control and audit reports are the main products of audit quality (Goh, et al. 2013). In addition, the quality of financial reporting loses its authority when external audit discovers that there is a weakness and/or inefficiencies in the internal control aspect of the financial statements (Cheng, et al. 2013). According to Morrell and Kopanyi (2014:250), the purpose of assessing internal control systems in the local government environment is to reduce the risk of fraud and the elements of corruption. Until recently, an internal control system has been viewed as a management system established to manage the risks so as to still attain the organisation's objectives. The term 'internal control' is defined as the *"process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations"* (IFAC, 2010).

Although ineffective internal control affects the quality of financial reporting and audit quality, Feng, et al. (2009:190) have concluded that internal control quality has a significant effect on the quality of financial management's reports, and thus also on the decisions made by management based on the information from the financial statements. Feng, et al. (2014) investigated whether deficiencies in internal controls over financial reporting have implications for the firm's operations, and found that indeed, the effectiveness of internal controls supports (correlates positively with) effective financial reporting (and thus the substance of the information used in decision-making). Similarly, Myllymäki (2013) confirms that the importance of

disclosing material weaknesses in internal control over financial reporting has a positive effect. Similar views are also presented by Garrett, et al. (2014). Feng, et al. (2009:207) argue that weak internal controls have broader negative implications as they affect management decisions related to production, capital investments, mergers and acquisitions, research and development, and the whole spectrum of financial management.

In addition, Skaife, et al. (2013) conducted a study to investigate the association between ineffective internal control and quality of financial reporting, and their findings revealed a positive relationship (i.e., poor control = poor reports). Effective internal control is considered as one of the mechanisms required for maintaining high quality financial reporting (Altamuro & Beatty, 2010), and is viewed as an element of management that brings success in achieving the organisation's objectives (Baltaci & Yilmaz, 2006). Of course, internal control's characteristics include maintaining an effective control environment, risk assessment, control activities, information and communication, and monitoring (Committee of Sponsoring Organisations (COSO), 1992).

### **5.3 FEATURES OF FINANCIAL MANAGEMENT IN LOCAL GOVERNMENT**

Financial management in the local government environment comprises a number of factors. In recognition of the significant role played by financial management, the following aspects of financial management in the local government environment are described in general terms with the specific purpose of identifying the factors that affect audit quality.

#### **5.3.1 Asset and liability management**

Asset and liability management is defined as the process by which an institution manages its balance sheet in order to allow for alternative interest rate and liquidity scenarios (Sheela & Bastray, 2015:34). Hence, in the South African local government arena, the need for asset and liability management is recognised in terms of section 63 of the MFMA, which requires the accounting officer of a municipality to be responsible for the management of the assets of the municipality,

including the safeguarding and the maintenance of assets, and the management of the liabilities of the municipality (RSA, 2003). As noted by Sheela and Bastray (2015:34), asset and liability management is concerned with risk management, and the provision of a comprehensive and dynamic framework for measuring, monitoring and managing the risks.

For example, National Treasury (2015) indicates that the national government's debt levels remain sustainable, because its debt has a long maturity structure and its exposure to foreign currency liabilities remains low, despite the global economic instability. However, the 2013/14 borrowing level of R162.9 billion will be decreasing to R151 billion in 2016/17 budget review. This is because financing a debt this large would require an increase in government's net loan debt from R1.4 trillion in 2013/14 to R2 trillion by 2016/17, which would increase the cost of servicing this debt over the same period from R101.3 billion to R139.2 billion.

The fact is that asset and liability management can be used to manage the risks associated with the finances of the organisations in relation to inflation and exchange rates, but this is an ongoing process and must be monitored and revised as all financial markets fluctuate. The 2014 Budget Review indicates that the servicing of government debt will be at 3.1 per cent of Gross Domestic Product in 2015/16. Such stability of debt is strong evidence that government has implemented effective control mechanisms to manage the debt (National Treasury, 2015).

### **5.3.2 Revenue management**

In order to collect revenues, municipalities need to ensure that their billing systems are accurate, that the residents are being sent relevant accounts, and that the collection of unpaid revenues owed to them is being done properly (National Treasury, 2015).

<b>R billion</b>	<b>2013/14</b>	<b>2014/15</b>	<b>2015/16</b>	<b>2016/17</b>
National allocations	449.3	489.4	522.3	553.0
Provincial allocations	414.9	444.4	477.6	508.3
<i>Equitable share</i>	338.9	362.5	388.0	412.0
<i>Conditional grants</i>	76.0	82.0	89.7	96.2
Local government allocations	83.7	90.8	100.0	105.2
<b>Total allocations</b>	<b>947.9</b>	<b>1 024.7</b>	<b>1 099.9</b>	<b>1 166.4</b>
<b>Percentage shares</b>				
National departments	47.4%	47.8%	47.5%	47.4%
Provincial	43.8%	43.4%	43.4%	43.6%
Local government allocations	8.8%	8.9%	9.1%	9.0%

**Figure 5.2: Government revenue management (Source: National Treasury, 2015)**

Most local governments still need to implement the following before their revenue management systems can be deemed successful (Morrell & Kopanyi, 2014:209):

- “A *credible enforcement system*. Political resistance may be attenuated if resources are allocated to improving the quality and quantity of public goods and services.
- *User charge set at a level to recover the operation and maintenance costs of service provision*. Local revenue policy needs to ensure the financial sustainability of municipal services.
- *Cost accounting systems by service*. To be able to set user charges at a level that ensures cost recovery for each service, the municipality must track the cost of each. It is practically impossible to set adequate charges without knowing the operation and maintenance costs of municipal services.
- *Affordable user charges*. Local governments need to adopt a policy regarding user charges that addresses issues of ability to pay which will enable them to solve the problems of non-payments of services.
- *Outsourcing revenue collection*. Outsourcing may be viable for user charges, including the administration of services. Ultimately the objective is sustainable service provision according to set standards.

- *Public-private partnerships.* Services financed by user charges, such as water and solid waste collection, in principle have the potential to be provided in partnership with the private sector; that typically ensures revenue collection efficiency, sustainability, and good standards in service provision”.

### 5.3.3 Expenditure management

Expenditure management involves the use of the allocated funds, and ensuring that they are used to achieve agreed priorities, and that information is available to enable governments to plan and monitor the performance of their programme (Morrell & Kopanyi, 2014:216). In South Africa, National Treasury plays an important role in managing all government expenditures. According to National Treasury (2015), local governments are expected to provide for basic needs such as water and sanitation, electricity, refuse removal, storm water management, transport and roads. Kaganova and Kopanyi (2014:292) state that municipal infrastructure may include the following:

- **“Water systems:** wells, river diversions, dams, transmission lines, water treatment plants, treated water storage facilities, distribution pipelines, fire hydrants, pumping stations, and water meters
- **Wastewater systems:** collection pipelines, manholes, pumping stations, wastewater treatment plants, sewage lagoons, sludge disposal areas
- **Storm drainage systems:** canals, ditches, pipelines, manholes, storm water inlets, flood control reservoirs, erosion protection, dikes
- **Solid waste collection and disposal facilities:** collection containers, collection vehicles, recycling facilities, landfills
- **Streets and roads:** roadway surfacing, adjoining sidewalks, adjoining lighting, signage, bridges and traffic control devices, drainage systems”.

As highlighted in the previous paragraph, National Treasury also determines the financial management standards and sets financial management guidelines in managing expenditures. Expenditure management should be seen as a continuous cycle that includes reviewing and setting policies, developing and approving plans, mobilising and allocating resources, implementing plans and controlling



expenditures, monitoring accounting expenditures, and evaluating and auditing expenditure performance (Morrell & Kopanyi, 2014:221). In the 2012/13 financial year, national expenditure amounted to R965.5 billion out of a total adjusted appropriation of R971.5 billion. This represents underspending of 0.6 per cent, compared with 1.1 per cent underspent in 2011/12. Contributing to this underspending, the municipalities spent R19.4 billion or 84.6% of their infrastructure grants in the 2012/13 municipal financial year, up from 78.5 per cent in 2011/12, and while still an improvement, it highlights the need for more effective expenditure management (National Treasury, 2015).

#### **5.3.4 Budgeting**

Alton, et al. (2013:2) state that budgets serve to build trust between citizens and the government. According to CIMA (2008:3), a budget is *“a quantitative expression of a plan for a defined period of time. It may include planned sales volumes and revenues, resource quantities, costs and expenses, assets, liabilities and cash flows”*. It is used as a key policy document which encompasses all government revenues and expenditure (OECD, 2002). As the budget co-ordinates and describes so many activities, local governments need to be smarter with their budget preparation to ensure efficient and effective linkages of budget components to service delivery (ACCA, 2010:3). For example, in South Africa the 2013 budget was the first to be linked to the new government plans as outlined in the National Development Plan (National Treasury, 2015). Accordingly, the consolidated budget expenditure for 2013/14 (i.e., national, provincial and municipal expenditures) shows that R1.15 trillion is needed by government to deliver and improve services. One of the key expenditure guidelines is to obtain value for money. Allocations for water, sanitation and electricity in rural municipalities have been increased substantially, to R4.3 billion, to be spent over the next three years. The requirement is that this is used to build capacity and strengthen systems for financial management and infrastructure delivery (National Treasury, 2013).

A budget is a management tool (CIMA, 2008) used to formally respond to the needs and expectations of the community. It can thus be seen as a tool to guide managerial decision-making and resource allocation (Rabiu, et al. 2015:29).

However, Amujiri (2013:58) argues that while resources are not always sufficient to service the needs the organisations would like to have addressed, budgeting remains the most tactically appropriate instrument for both decision-making and allocation of resources. Therefore, regardless of the degree of local participation, communities and citizens at large have their own expectations of the local government budgets. It is equally important for the local business communities to participate in the municipal budget preparation processes. Budget preparation provides operational and financial plans for the attainment of the local government's goals (Venkateswaran, 2014:93). In the South African local government sphere, budget preparation offers a formal process that enables the community at large to gain a sense of what the municipality is planning to achieve during the forthcoming financial year. Budget preparation helps all organisations to plan and control operations by being aware of the managerial strategies that will be required to support the budget financially (CIMA, 2008). The preparation of a budget requires detailed attention to the following issues:

- Firstly, identify *public goods*: these include the type, quantity, and quality of goods and services that the public sector produces that are not evaluated and adjusted through the market mechanism.
- Secondly, identify *public interest goods*: these include the goods and services provided by the public sector that are often among the most critical to the public interest.
- Thirdly, acknowledge the *immense scope of the task*: this deals with the diversity of modern government activities and is a prerequisite to making comprehensive, thoughtful, and systematic planning and to orderly decision-making.
- Fourthly, ensure public *participation*: government planning and decision-making should generally take place as a joint process involving citizens, their elected representatives, and the executive branch (Venkateswaran, 2014:93).

It should be noted that budgeting is considered to be a type of financial management which creates a better flow of information, improves decision-making and thus enhances service delivery by local governments. Furthermore, CIMA (2008:5) highlights how the planning and control mechanisms support the achievement of

strategic plans. This is done by: translating the long-term plan into an annual work programme; coordinating the efforts of various departments of the organisation to ensure they are working in harmony; requiring managers to consider the relationship between their operations and those of other departments (to prevent unilateral and self-interested decisions, rather than those supporting the company's best interests); and communicating plans to those who will be held accountable.

As it stands, the government's expenditure budget for 2013/4 was R1.15 trillion (National Treasury, 2013), of which local governments have been allocated R72 billion over the next three years (with the likelihood of an increase in the next budget cycle) for use in municipality-specific projects, and over and above their national and provincial service delivery obligations. Therefore, once the budget has been approved by the National Assembly, then the portion of R72 billion can be fully implemented and managed. Hence, as indicated above, the national budget has the following benefits for the municipal community, and its elected officials and management (Venkateswaran, 2014:125):

- ***“It gives community members a say:*** Ordinary people have more voice, and they get to make real decisions.
- ***It produces better and more equitable decisions:*** Local residents know best what they need, and budget dollars are redistributed to communities with the greatest needs.
- ***It develops active and democratic citizens:*** Community members, staff and officials learn democracy by practicing it. They gain more understanding of complex political issues and community needs.
- ***It builds communities and strengthens community organization:*** People get to know their neighbours and feel more connected to their city. Local organizations are able to spend less time lobbying, and more time deciding policies themselves. Budget assemblies connect groups and attract new members.
- ***It connects politicians and constituents:*** Politicians build closer relationships with their constituents. Community members get to know their elected officials and local governments.

- ***It makes government more accountable and efficient:*** Local officers are more accountable when community members decide on spending in public assemblies. There are fewer opportunities for corruption, waste, or costly public backlash”.

It is against this backdrop that Amujiri (2013:60) identifies key elements of budgeting. These include:

- an agreement on the objectives that govern the entire contents of the budget and guide the officials' behaviour during its implementation;
- a brief review of the previous year's budget performance, which includes the summary of actual revenue and expenditure in relation to their estimates;
- a detailed estimate of revenue, which provides details of expected receipts from all sources;
- a detailed estimate of expenditure, which proposes financial allocations to services, programmes and projects;
- a budget should contain detailed information about the proposed level of expenditure, with precise explanations to justify any deviations from previous levels of expenditure in past annual budgets; and
- a well-planned budget should facilitate quick and proper understanding of the inter-relationships between the various components of the budget and its estimates.

#### **5.3.4.1 Budget preparation**

Budget preparation is a technical financial process (CIMA, 2008). It is also influenced by the politics of local government (Amujiri, 2013:57). The preparation of the budget is a lengthy process spanning many months. It can be said to start in August at the time the mayor tables the Schedule of Key Deadlines and concludes in June or early July the following year, when the mayor approves the Service Delivery and Budget Implementation Plan (SDBIP) and the annual performance agreements with senior managers (National Treasury, 2004). The formalisation of the budget preparation process of the municipalities (the pulling together of data and outputs from processes affected by the Key Deadlines schedule), begins not later than 01 April,

as the annual budget is expected to be tabled in the municipal council at least 90 days before the beginning of the financial year. (For most municipalities this is from 01 July to 30 June of the following year.) In the period between April and May, the municipalities are expected to have public consultations on the draft annual budget. As the process continues, by the end of May all municipal councils are expected to consider and finalise their annual budgets (and input from stakeholders) for approval by the municipal council on or before the 30 June (National Treasury, 2006). It is within this framework and timetable that public accountability and participation issues are addressed as part of the budget preparation process (Alton, et al. 2013:5).

Thereafter, once the budget has been approved and ratified by the local government authority (Amujiri, 2013:59) it cannot be changed during the financial year (Dugdale & Lyne, 2006; CIMA, 2008). This is to preserve its value as a fixed reference point, and any changing circumstances and new information which materially affects the budget can only be accommodated by so-called budget flexing, or rolling budgets (CIMA, 2008). “A rolling budget is also known as a continuous budget, which is continuously updated by adding a further accounting period (month or quarter) when the earliest accounting period has expired” (CIMA, 2008).

In order to be able to initiate and implement the budget process, Morrell and Kopanyi (2014:261) suggest that the local government must be able to:

- establish clearly defined policy objectives, along with the desired outputs and impacts;
- design public programs and targeted services to bring about the desired outputs;
- calculate a realistic estimate of the resources needed to properly implement the programme;
- develop an effective mechanism to coordinate with various departments and special interest groups;
- have budget discipline;
- have procedures for estimating the forward costs of programmes;
- implement an effective monitoring and evaluation system that provides policy makers with critical information regarding the effectiveness of the programme; and

- have the will and strength to generate political leadership committed to improving expenditure management systems and procedures and increasing the level of transparency in government.

### **5.3.5 Cash management**

Cash has been defined by Lienert (2009) as notes, coins and deposits held on demand by government institutions with financial institutions such as banks. According to Deloitte (2013b:2) the management of cash in the local government environment requires that municipal management takes appropriate actions to maintain adequate levels of cash for immediate operational and capital requirements, and to invest so-called “idle cash” so that the entity is able to benefit from the market related investment returns. As Morrell and Kopanyi (2014:251-252) state, the objectives of cash management are to bring funds into the local government’s finances as quickly as possible and to pay the funds out as efficiently as possible, while making effective use of the funds until they are needed for operating expenses. Cash management has also been recognised as the way that business organisations manage their financial affairs (including revenue, cash flows, and investments), in order to determine and increase the financial health of the organisations (Lienert, 2009). Financial health depends on the business’s ability to earn and collect revenues (Deloitte, 2013b). According to Williams (2010), cash management in government may be defined as “the strategy and associated processes for managing cost effectively the government’s short term cash flows and balances, both within government and between government and other sectors”. This definition highlights three key aspects of the process, requiring that the management process addresses both policy issues and the design of the more routine processes; that they address the management of cash flow and cash balances, and in that this gives rise to different challenges, addresses these challenges effectively; and cash management within the government sector and in government’s interaction with other sectors (Williams, 2010).

Cash management is reflected in the literature on financial management (John, 2014; Das, 2015). According to Lienert (2009) effective cash management

contributes to a smooth financial management process when it meets its objectives.

These objectives are:

- to ensure that adequate cash is available to pay for expenditures when they are due;
- revenues are collected when due;
- to borrow only when needed and to minimize government borrowing costs;
- to maximize returns on idle cash in order to avoid the accumulation of unremunerated or low yielding government deposits in the central bank or in commercial banks; and
- to manage risks, by investing temporary surpluses productively, against adequate collateral.

Williams (2010) presents the key characteristics of good cash management practice in government entities as follows:

- Modern systems: an adequate transaction processing and accounting framework (processing government transactions with few handling steps, reliance on electronic transactions); use of modern banking, payment, and settlement systems;
- ability to make accurate projections of short-term cash inflows and outflows;
- strong institutional interaction, covering in particular: information sharing between the cash managers, revenue-collecting agencies and spending ministries (and any relevant ministry branch offices);
- strong coordination of debt and cash management: formal agreements between the treasury and the central bank on information flows and respective responsibilities; and
- use of short-term instruments (treasury bills, repo and reverse repo, term deposits, etc.,) to help manage balances and timing mismatches.

The Chartered Institute of Management Accountants (CIMA) (2009) advocates the use of four principles regarding cash management. These are:

- **Principle 1:** Cash is not given – It is not the passive, inevitable outcome of your business endeavours. It does not arrive in your bank account willingly. Rather, it has to be tracked, chased and captured. You need to control the process and there is always scope for improvement.
- **Principle 2:** Cash management is as much an integral part of your business cycle as, for example, making and shipping widgets or preparing and providing detailed consultancy services.
- **Principle 3:** Good cash flow management requires information. For example, you need immediate access to data on creditworthiness; current track record on payments; outstanding receipts; suppliers' payment terms; short-term cash demands; short-term surpluses; investment options; current debt capacity and maturity of facilities; and longer-term projections.
- **Principle 4:** Managing cash flow is a skill and only a firm grip on the cash conversion process will yield results.

### 5.3.6 Debt management

Debt management is “the process of establishing and executing a strategy for managing the government’s debt in order to raise the required amount of funding at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk. It should also meet any other public debt management goals the government may have set, such as developing and maintaining an efficient market for government securities” (International Monetary Fund (IMF), 2014).

In April 2014 the IMF issued a revised guideline for public debt, with the intention that the publication would provide clear guidelines to assist government treasuries in different countries in their management of public debts. The guideline was developed as part of a broader IMF and World Bank initiative to strengthen the international plan to promote policies and practices that contribute to financial transparency and to minimise countries’ external risks (IMF, 2014).

Werner (2014) argues that a formal debt management strategy is needed in order to enhance debt management efficiencies. The guideline proposed by the IMF



recognises that using a wider view of strategies could influence debt management in the public sectors. The IMF (2014) further identifies that:

- “the risks inherent in the government’s debt structure should be carefully monitored and evaluated. These risks should be mitigated to the extent feasible, taking into account the cost of doing so;
- in order to help guide borrowing decisions and reduce the government’s risk, debt managers should consider the financial and other risk characteristics of the government’s cash flows;
- debt managers should carefully assess and manage the risks associated with foreign currency, short-term and floating rate debt; and
- there should be cost-effective cash management policies in place to enable the authorities to meet their financial and budgetary obligations as they fall due”.

In South Africa, the current democratic government has put measures in place to alert investors, citizens and the public at large (including the international community) to the fluctuations in the processes of management of government debt. According to the South Africa Year Book (2013/14), Government is committed to remaining within the expenditure ceiling set out in the budget. This is despite the fact that the government’s debt-service costs peaked at 2,8% of GDP in 2013/14, which means that the government’s debt management cost is sitting at negative balance. This demands a prudent management of debt, and should be one of the top priorities.

In the municipal management arena, an effective debt management policy is characterised by an appropriate revenue collection system that is aligned to the Municipal Systems Act, and the revenue management and debt collection policies of the municipality; accurate calculations and timeous monthly reporting of revenue due and outstanding debtors, thereby enabling appropriate monitoring and oversight of debt collection practices and timely action with regards to impairments or waivers of debts; allocating sufficient capacity to proactively drive the revenue management and debt collection functions and policies, in order to intensify revenue collections (Deloitte, 2013b:3).

### **5.3.7 Performance management**

Performance management has become a key element of any public sector administration (CIMA, 2010a). It is defined as “a continuous process of identifying, measuring and developing performance in organisations by linking each individual’s performance and objectives to the organisation’s overall mission and goals” (Aguinis, 2002:2). Performance management has become a challenge in the public service (Arnaboldi, et al. 2015), as it is in almost all private sector entities. In the case of the local governments in South Africa, they are suffering reputational damage, and are risking even more, because of the inaccurate use of information to measure the outcomes of service delivery. The most prominent of the challenges regarding inaccurate information in most municipalities relate to their difficulties in compiling credible operational budgets (National Treasury, 2014). Without realistic and credible budgets, performance management becomes ineffective and irrelevant to judging the well-being of the local government and its efforts to deliver essential services in an efficient and economical manner.

In response to all the performance management challenges facing it, the South African government now requires the measurement of performance information which is designed to indicate whether the government institution is meeting its aims and objectives (National Treasury, 2009). According to Roos (2009), performance management is intended to eliminate any undesirable effects and to encourage only desirable actions. The government has become increasingly aware of the negative aspects of local government activities over the past two decades. Acknowledging that performance management across South African public sector organisation is critically ineffective, the national government introduced measures to make the collaboration between individual municipalities’ plans and the national government’s plan more harmonious (Presidency, 2011). The national government’s plan is aimed at showing the world and the community at large (including business) that they are concerned about the development of the country. The main strategic intentions of government are:

- to “eliminate poverty by reducing the proportion of households with a monthly income below R419 per person from 39% to zero and the reduction of inequality;
- increasing employment from 13 million in 2010 to 24 million by 2030;
- broadening the country’s ownership of assets by historically disadvantaged groups;
- ensuring that all children have at least two years of pre-school education and that all children can read and write by Grade 3;
- providing affordable access to healthcare;
- ensuring effective public transport” (Presidency, 2011).

Therefore, it is in this context that the National Development Plan has been developed to deal with these challenges by

- “uniting all South Africans around a common programme to achieve prosperity and unity;
- promoting active citizenry to strengthen development, democracy and accountability;
- bringing about faster economic growth, higher investments and greater labour absorption;
- focusing on key capabilities of people and state;
- building a capable and developmental state; and
- encouraging strong leadership throughout society to work together to solve problems” (Presidency, 2011).

According to IFAC and CIPFA (2014:39), a performance management system is concerned with the mechanisms needed to monitor service delivery throughout all stages in the process, including planning, specification, execution, and independent post-assessment review. However, the Presidency (2014) and the AGSA (2014) highlight several challenges that affect the efficient, economical and effective running of the municipalities, from both performance monitoring and audit perspectives. These challenges include weak political leadership across all spheres and levels of the civil service; a lack of technical skills and relevant competencies; a lack of understanding of policies and procedures; political deployments that do not always

match personal competencies with the requirements of the appointments; corruption is rife at all levels, with no consequences; weak financial management and low budget spending, and a lack of oversight and accountability (Presidency, 2014; AGSA, 2014).

In order to deal with the impact of the identified challenges, IFAC and CIPFA (2014:28) recommend that the governments should “continuously monitor whether the intended outcomes are still valid; whether they should be adapted for new insights; the public entity’s service delivery activities can still effectively and efficiently achieve those outcomes; and whether there are any changes in the internal or external environment (the context) that might pose a risk, positive or negative, to achieving the outcomes and that need to be managed”.

Most of the listed challenges are common in most municipalities, and the AGSA repeatedly reports on recurring findings that there are unresolved problems regarding management and accounting skills, and ongoing failures to comply with supply chain management regulations (AGSA, 2014). All of these routinely increase the unauthorised and fruitless and wasteful expenditure totals in the municipal financial statements; and management’s attitude and conduct regarding this irregular expenditure is frequently one of indifference (National Treasury, 2014). And all the while poor service delivery levels deteriorate even further, and improper financial management becomes more firmly entrenched.

#### **5.4 SUMMARY OF THE CHAPTER**

This chapter presented a review of the literature on financial management and audit outcomes. The literature revealed that the quality of financial management in the local government sphere affects the quality of the audit as presented in the audit reports. Furthermore, the concepts within the discipline of financial management have been found to offer numerous techniques that could assist local governments to use their resources in line with internal controls and budget processes, and also to operate in a transparent way to ensure accountability to citizens. The literature further reveals that the monitoring of financial management systems through audit enhances local government’s ability to achieve compliance with accounting and

statutory regulations and guidelines, and to identify risks. The next chapter presents a review of literature examining municipal governance and audit outcomes.

## **CHAPTER 6**

### **MUNICIPAL GOVERNANCE AND AUDIT OUTCOMES**

#### **6.1 INTRODUCTION**

This chapter reviews relevant literature on the relationship between governance and audit outcomes. The discussion focuses on the association between governance and audit quality, and between the audit committee and governance. The review of published literature helps, by identifying similar studies, to identify research gaps and thus to indicate avenues for further investigation and in-depth research. A summary of the chapter concludes this literature review and is presented as the last section.

#### **6.2 GOVERNANCE AND AUDIT OUTCOME**

This subsection discusses the concept of governance and the link between governance and audit outcome.

##### **6.2.1 Concept of governance**

Governance is explained as a concept that embraces political, economic and administrative authority as it is exercised in the management of a country's affairs (United Nations Development Programme (UNDP, 1997; International Monetary Fund (IMF), 2007). On the other hand, the concept of governance is also a neutral term used for the complex mechanisms, processes, relationships and institutions through which citizens and groups articulate their interests, exercise their rights and obligations, and mediate their differences (UNDP, 1997). Extending these ideas further to business enterprises, governance comprises the arrangements put in place to ensure that the intended outcomes are defined and achieved (Chartered Institute of Public Finance and Accountancy (CIPFA) and the International Federation of Accountants (IFAC), 2014). Of course, within these attempts to define governance there is a wide range of variations in meaning depending on the people and organisations using the term. Thus, depending on the type of organisation using the term, governance refers to social coordination (Capano, et al. 2015; Van den

Berghe, 2009; Bevir, 2010); while Bevir (2010:4) and Stoker (1998:17) view governance as that group of activities that reflect the interests of the social sciences investigating the way communities are governed. And because civil society organisations are of paramount importance in the pursuit of effective governance of communities (African Peer Review Mechanism (APRM), 2014:72), governance is also concerned with the conditions of ordered rule and collective action (Capano, et al. 2015; Stoker, 1998). This is reflected in the fact that, in the past twenty years, the word “governance” has become a popular catch-all term that refers to the behind-the-scenes actions (usually administrative) that keep the government’s work honest and on track. By the same token, the concept of governance has also become a “phenomenon related to the steering of society [’s] developments” (De Vries, 2013:4). This has been manifest as a dramatic rise in interest in the theory of governance as the attention of affected citizens and academics has focused on the processes and interactions that constitute the rule of law (Bevir, 2010:2). In many respects this interest is also responsible for having brought together the social interests of society in the development of policies, practices and the patterns of governing. Academic literature on the theory of governance reveals a wide diversity of opinion as to what “it” is. For example, in a study of good governance practices in the New Partnership for Africa’s Development, Maserumule (2011:308) indicates that “the communities play a key role, in a collaborative manner with government, in the pursuit of what is in their interests”. Taking an almost diametrically opposite view, Shah (2006) argues that at the heart of local government there should be governance, which embraces the notion that utilisation of public resources is achieved by being responsive to the needs and accountable to the interest of the communities they serve.

Of course, the concept of governance in the South African context (in both private and public sector organisations), achieved top-of-mind attention from the date of publication of the first Report and Code of Governance issued by the King commission (three reports and codes have been issued to date, with King IV scheduled for publication in the near future) (IOD, 1994; 2002; 2009). Because public sector organisations are required to be compliant with the core recommendations in these reports, they are expected to be seasoned practitioners of “good governance” (Maserumule, 2011; Stoker, 1998). Bevir (2010:15) has observed

that governance has been a prominent topic of interest across the spectrum of the social sciences. Stoker (1998:18), meanwhile, summarised his findings into five propositions about governance: 1) that it defines the public sector organisations; 2) it identifies the misleading boundaries and assigns responsibilities for tackling social and economic issues; 3) it identifies the power dependence involved in the relationships between institutions involved in collective action; 4) it is about autonomous self-governing networks; and 5) it also recognises the capacity of individuals and organisational divisions to get things done independently of the power of government to command or use authority. Hence, it sees government as able to use governance as a new set of tools to guide its actions in serving its public.

In essence, good governance can result in the improved functioning of public sector organisations (Maserumule, 2011; Matshabaphala, 2014; Grant Thornton, 2015). Hence, the effective implementation of good governance policies and processes has always been a desirable objective in local government institutions (Begum, et al. 2014; Jørgensen & Sørensen, 2012:71). Good governance involves allowing the characteristics such as participation, transparency, accountability, rule of law, effectiveness and equity to be fully present in all aspects of an organisation's business (UNDP, 1997). According to IFAC (2013), good governance is one of the important elements of all governments as it demonstrates that the public sector encourages better decision making and efficient use of resources, and it strengthens accountability for the stewardship in the management of public resources. Hence, Stoker (1998) and Bevir (2010) affirm that those entrusting their resources to the stewardship of others should benefit from the assurance that good governance provides. Stated somewhat differently, Abdellatif (2003:3) is of the opinion that governance should occupy centre stage in the development of organisational strategy and policy prescriptions.

The implementation of good governance practices in many instances evolved from an organisation's effectiveness when promoting and practicing accountability (Andersen, 2015; Zadek & Radovich, 2006; Van den Berghe, 2009; Bekiris, 2013). In other words, for a local government entity (municipality) to be accountable and responsive to the citizenry, it must first respect the rule of law by ensuring the sustainable provision of basic services to all residents in their communities (SALGA,



2014). The concept of governance had been talked about by many in the private sector, public sector, government sector, and other formal and informal organisational structures (Graham, et al. 2003:6) before gaining sufficient clarity of statement to be able to be included in legislation and regulations. Even so, the use of the concept was initially intended to substantiate the adherence to ethical conduct, and to promote accountability, sound and sustainable business practices and proper decision making processes, amongst others (Andersen, 2015; Van den Berghe, 2009; Fassenfest, 2010).

As stated in the preceding paragraph, the practice of good governance promotes accountability, and Grindle (2004:525) observes that the challenges presented by good governance are always going to emerge when governments perform poorly, when resources are wasted, services go undelivered and citizens (especially the poor who are denied social, legal and economic protection) experience irregularities in the delivery of basic services across their communities. Moreover, as the AGSA (2014) and the Presidency (2014) have pointed out, South African local government structures all face similar challenges, which have at their root a poor understanding of (and willingness to apply) acceptable governance processes, and this is manifest in the poor quality of audit reports.

These less-than-desirable audit reports include the highlighting of uncorrected audit findings from previous audits, material misstatements in the financial statements, non-compliance with and inaccurate reporting of performance information, audit committees not executing their responsibilities, internal audit recommendations not being taken seriously by management, poor record management, and generally poor governance which leads to corruption and weak risk management (AGSA, 2014; Presidency, 2014). Deloitte (2011) also reports that the challenges of demonstrating effective governance are common in all of the South African local governments. In addition, these challenges of governance raise a host of questions about what needs to be done, when it needs to be done, and how it needs to be done (Grindle, 2004:525). The challenges posed by, and the opposition to the implementation of good governance practices can also be attributed to a widespread lack of accountability, honesty and openness in public offices (AGSA, 2014; Presidency, 2014; Deloitte, 2011). Thus, the fact that governance requires accountability to

manage public resources is justification for the pursuit of good governance throughout the public sector's business.

Accountability is the key component of good governance. Unfortunately, within the last two decades thirteen (13) municipalities have been cited by the Parliamentary Monitoring Group for their poor governance: essentially, their financial governance and administrative governance was (and often remains) non-existent, and their service delivery efforts were described as “dysfunctional” (Parliamentary Monitoring Group, 2013). These municipalities include two (2) in the Northwest Province, two (2) in the Free State, three (3) in the Eastern Cape, two (2) in Mpumalanga and four (4) in Kwazulu-Natal. The details of their poor governance abilities start in their financial and administration departments; the councillors exercise poor governance and management of council matters; political infighting within the councils is rife, which in turn compromises the administrative abilities of the municipalities, and, compounded by their poor governance abilities, results in increasingly visible service delivery shortfalls and protests; their continuous financial irregularities result in the municipalities receiving recurring poor audit opinions; they all fail to respond to audit findings and have not implemented audit recommendations, and they have weak budgetary control and spending processes (Parliamentary Monitoring Group, 2013). Unfortunately, this South African situation is not unique: implementing effective governance has been a challenge faced by many local governments elsewhere in the world (Grant Thornton, 2015). Poor governance in any single part of an entity can have disastrous consequences for effective governance throughout that entity, whether it is a local government or other state owned entity, or a private sector enterprise. The role players manning the first line of defence are the internal audit functions, audit committees, Municipal Public Accounts Committees (MPAC), external auditors, and municipal councils. Failure to perform, either by virtue of incompetence or premeditation, can undermine the effectiveness of the entire local government. Effective governance is therefore vital (Petra, 2007; Andersen, 2015; Van den Berghe, 2009) to the wellbeing of the entity and its stakeholders.

### **6.2.2 Link between governance and audit outcomes**

Governance provides strategic direction in the running of the organisation and also ensures accountability (Abdellatif, 2003; Fassenfest, 2010; Jørgensen & Sørensen, 2012; Bevir, 2010; Stoker, 1998; Grindle, 2004; Lewis, et al. 2015; Maserumule, 2011; Matshabaphala, 2014; Begum, et al. 2014; Shah, 2006; De Visser, 2009). In so far as it could be ascertained, strong controls, proper regulations and audit quality (International Federations of Accountants (IFAC), 2014) are fundamental to driving strategic direction, performance measurement, modern accounting principles, and transparency in local government administrations (De Visser, 2009). Therefore, governance affects the audit quality in many ways (Gajevszky, 2014; Fooladi & Farhadi, 2011; Alrshah, 2015), through its effect on internal audit's authority (Mohamed, et al. 2012; Sarens, et al. 2012), and risk management (Subramaniam, et al. 2009; Drew, et al. 2006; IOD, 2009; Bromiley, et al. 2015; Quon, et al. 2012), and the effectiveness of the audit committee (Morrell & Kopanyi, 2014; Lisic, et al. 2015; Zaman & Sarens, 2013; Inaam & Khamoussi, 2016).

There are direct and indirect links between the role of governance functions and audit outcomes or audit quality. Direct links and relationships have been investigated in multiple studies (Gajevszky, 2014; Fooladi & Farhadi, 2011; Alrshah, 2015) of the relationship between governance and audit quality. These studies have confirmed that governance plays an important role in driving the audit quality. However, a small minority of studies (Deumes, et al. 2012; Beisland, et al. 2015) have found a negative association between audit quality and governance. Instead, these researchers found that the dominant positive relationship existed between audit outcome and the quality of financial controls. In fact, despite the fact that good governance is a great contributor to ensuring internal control quality (Li, 2015; Yeoh & Jubb, 2001; Lin, et al. 2014), auditors themselves put more reliance on the quality and effectiveness of specific internal controls as their experience suggests they are the key contributors to the quality of the audit report (Khlif & Samaha, 2014).

Despite the difficulty in measuring the direct and particularly the indirect influence of governance on audit quality, effective governance is known to sustain and enhance audit quality (Gajevszky, 2014; Fooladi & Farhadi, 2011; Alrshah, 2015; Adeyemi &

Fagbemi, 2010). By examining the role of governance in sustaining audit quality, Alrshah (2015) developed a framework for analysing the effect of governance on audit quality. Through performing multiple analyses, the study suggested that the auditor's performance and the responsibility of the auditor are the factors affecting the audit quality. In addition, the study showed that the role of governance is seen as a key influence in the audit process (Alrshah, 2015). Similar results have also been identified by Fooladi and Farhadi (2011) in their study of governance and the audit process. Their study also revealed that governance has most influence on audit quality "when the auditors are planning an audit engagement" (Fooladi & Farhadi, 2011:306). Therefore, based on their studies, auditors are also recognised as a component of governance as they monitor the quality of financial reporting.

The relationship between governance and audit quality is that effective governance adds significant value to the quality of the audit outcome. However, there are indirect factors which negatively affect such a relationship. Al-Ajmi (2009) indicates that the most common factors which "saturate the link between governance and audit quality" relate to non-audit services performed by auditors. These types of audit services often impair the auditor's independence, which also shows as a negative relationship relative to the audit outcome (Al-Ajmi, 2009). Of course, many studies have found that the audit quality suffers when the auditor is willing to accept non-audit services from the client (Causholli, et al. 2015; Quick & Warming-Rasmussen, 2015). It is therefore essential for the governance function, as an influential factor promoting audit quality, to assess the process and scope of the auditor's appointment(s) in order to limit the risk of compromising the auditor's independence.

In addition, and to further understand the link between governance and audit quality, Lin and Hwang (2010) used a meta-analysis of 12 significant relationships from 48 previous studies to review the relationship between earnings management, audit quality and governance. Their study concluded that the effect of the relationship is inconsistent, because of the diversity of variables being tested to measure audit quality. While Cohen, et al. (2002) also surveyed the relationship from the perspective of the auditors, and also found inconsistent results; they concluded that as there are no specific auditing standards that relate to managing the effect of governance on the audit process, the audit quality measures will always vary. An

effective governance process is an important contributor to the success of the audit. Pursuing this line of thought, Ernst and Young (2013) are of the opinion that governance should assess the audit process to ensure that it has been effectively tailored to evaluate the risks facing the organisation. In addition, the governance function should ensure that the audit team is technically strong and also should have an understanding of the control environment. Therefore, it can be generalised that there is a relationship between governance and audit quality (it is essentially symbiotic), which suggests that the governance function's involvement in the audit process should be taken into account as it improves audit quality through its insights and inputs at all levels of the accounting/auditing/compliance continuum.

Despite the relationship between governance and audit quality discussed in the preceding paragraphs, there are also many reasons why governance is not causally linked to audit quality. For example, Zureigat (2011) surveyed 198 companies to establish whether ownership structure had an impact on audit quality. The study found that ownership has a negative relationship with audit quality – the more closely the business is associated with the owner, the poorer the audit quality. Of course, a wide range of studies have also investigated a variety of different factors associated with these relationships. Enofe, et al. (2013) also investigated the determinants of audit quality, such as its relationship to the security of the auditor's tenure, the size of the audit team and extent of the audit, the board's independence and the entity's ownership structure. Their findings revealed that only the board's independence indicated a positive relationship with audit quality, while audit quality exhibited a negative correlation with audit tenure, size and ownership structure. Therefore, the demonstration of a positive relationship between the independence of the governance functions and audit quality suggests that when the governance processes are active in the business and thus apparent even at the early stages of the audit process, a positive audit outcome is highly probable.

In a similar approach to that used in the study of the relationship between governance and audit quality, Shan (2014) also used different factors to measure audit quality. The results show a significant positive relationship to exist between governance and audit quality. Other factors, including the size of the supervisory board, the independence of the board and the frequency of their meetings, showed

no impact on the audit quality. To this end, Alshammari (2014) also studied the spectrum of governance functions and aspects, and their relationship to audit quality, and the results confirmed those previously discussed, and also confirmed a negative relationship between the ownership structure and audit quality. Thus, the similarity of the research results into the effects of all these governance factors on audit quality (Alrshah, 2015; Lin & Hwang, 2010; Enofe, et al. 2013; Adeyemi & Fagbemi, 2010), it can be summarised that improving the quality of governance does improve the audit quality, and the effectiveness of governance's role also correlates positively with a better audit performance.

Since there is no single factor to measure the effectiveness of the relationship between governance and audit quality, studying the link between the two variables can be approached by studying the influences of various other factors. For example, governance roles performed by the audit committee play an important role in enhancing the audit quality (Zureigat, 2011). Thus, the International Auditing Standards (ISA) 260 (SAICA, 2014/15) requirement that the auditor communicates with those charged with governance on specific matters relating to the auditor's responsibilities (the planned scope and timing of the audit, any information about threats to auditor's objectivity and the significant findings from the audit), appears appropriate and effective. As Inaam and Khamoussi (2016) has found, the audit committee, as part of governance, exerts a positive impact on the audit quality achieved, through receiving the auditors' communications that provide those charged with governance an unbiased insight regarding the performance of management in fulfilling its responsibilities for the preparation of the financial statements. This communication channel also provides insights into the entity's financial reporting practices, including the operation of internal controls; provides recommendations for improvements to the entity's financial reporting process, and general information that enables the audit committee to fulfil their governance responsibilities effectively (IFAC, 2014). Despite this, Christensen, et al. (2013) identified that investors do not necessarily regard the work of the audit committee, as a component of governance, to enhance audit quality, and instead regard the quality of the reputation of the audit firm as their audit quality assurance indicator. Ball, et al. (2015) concur that there is a positive relationship between audit firm and audit quality. Hence, the quality of the

audit firm employed may only provide generic information about the audit quality that the audit client can expect (Bills & Cunningham, 2015; IFAC, 2014).

Governance, because it is multi-faceted, may influence the audit quality in a variety of ways (Alrshah, 2015; Lin & Hwang, 2010; Enofe, et al. 2013; Adeyemi & Fagbemi, 2010; Bills & Cunningham, 2015; Christensen, et al. 2013). Therefore, those charged with governance are found to be in a better position to influence the quality of the audit through a variety of actions. These include providing views on financial reporting risks and areas that need an auditor's attention; ensuring that sufficient audit resources are allocated for the audit to be effectively performed; providing an independent view on issues affecting the audit, and proving resolutions to disputes; assessing how management responds to challenges presented by the auditor during the audit, particularly with respect to the assessment of fraud risk, management's estimates and assumptions, and the choices of accounting policies; and by creating an environment in which management is not resistant to being challenged by the auditors and not overly defensive when discussing difficult matters (IFAC, 2014).

Effective governance rests on the presumption of an efficient internal audit function, risk management processes and diligent audit committee, and these are discussed in the following sections.

#### **6.2.2.1 Internal audit and governance**

Internal audit contributes to audit quality (Chambers & Odar, 2015; Mohamed, et al. 2012). It does so by helping management to identify risks and by the monitoring of controls (Sarens, et al. 2012; Motubatse, 2014). It makes its contribution to audit quality through being competent and diligent in performing their duties (Abbott, et al. 2015). Such competencies include information technology skills and professional certifications in both accounting and auditing (Mohamed, et al. 2012; Wu, et al. 2016; Abbott, et al. 2015).

The focus of this chapter is on the correlation between governance and audit quality. The internal audit function has become a statutory part of governance in the South African municipalities, with an important potential to influence the municipality to

achieve its service delivery objectives. For example, section 165(1) of the MFMA requires each municipality and each municipal entity to have an internal audit function (RSA, 2003). Section 165(2)(b)(i)-(vii) requires that each municipality's and municipal entity's internal audit unit must advise the municipal accounting officers (AOs) and report to the audit committee on the implementation of the internal audit plan and on matters relating to internal auditing, internal controls, accounting procedures and practices, risk and risk management, performance management, loss control, and on compliance with the MFMA, the Division of Revenue Act's annual requirements, and any other applicable legislation (RSA, 2003).

Internal audit's effectiveness is influenced by the audit quality, audit process, management support and attitudes and competences of the internal audit team (Mihret & Yismaw, 2007:470; Arena & Azzonne, 2009:43). Hence, the internal audit function has a role in governance (Gramling, et al. 2004). Feizizadeh (2012) indicates that the effectiveness of internal audit should be measured against the expectations of the audit committee and management. As noted by Soh and Martinov-Bennie (2011:614), the effectiveness of internal audit is further measured in terms of the work it performs, its staffing (numbers and members' competences), its independence and its relationships with management, external auditors and the audit committee. Hence, the primary purpose of evaluating internal audit's effectiveness is to ensure that it adds value to the organisation by appropriately evaluating the internal control systems, risk management approaches and governance (IIA, 2012; Arena & Azzonne, 2009). Therefore, an internal audit function is directly involved in the activities of governance (Mihret & Yismaw, 2007; Arena & Azzonne, 2009; Gramling, et al. 2004; Feizizadeh, 2012; Soh & Martinov-Bennie, 2011).

Effectively, internal audit's role supports, and compliments the entity's other governance functions. It adds value to the structures of governance because of its role in control, risk and evaluation of governance processes (Christopher, 2015). The effective contribution of internal audit to governance has been proved by many studies (Chamber & Odar, 2015; Christopher, 2015; Suyono & Hariyanto, 2012), all of which have found a significant relationship to exist between governance and internal audit, and they have also concluded that there is a need for internal audit to provide independent assurance to governance.



Cattrysse (2005) has argued that the relationship between internal audit and governance depends on the role internal audit is required to play within the organisation. In addition to the relationship between internal audit and governance, Suyono and Hiriyanto (2012) have also studied the relationships between internal control, internal audit and governance. Their results show that internal audit and internal control have a significant, positive relationship with governance. El-Kassar, et al. (2014) have also studied the effect of internal audit's performance on governance quality and have found that the internal audit function does influence governance because of its high level of independence and expertise. Therefore, it can be summarised that internal audit puts governance at ease through its role in assessing and evaluating the activities of the organisation.

Internal audit does not exist in a vacuum (Modibbo, 2015:59): it exists to enhance governance (Gramling, et al. 2004; Mihret & Yismaw, 2007; Arena & Azzonne, 2009). It does so by helping public sector organisations to ensure transparency, integrity, quality and improved service delivery (Ahmad, et al. 2009). It has a mandatory obligation to contribute to the improvement of the efficacy of systems that support governance processes (IIA, 2012). In the South African local government arena, the role of the internal audit function is to improve an organisation's operations by acting as an independent section within the local government. This is required by the Municipal Finance Management Act, which also requires the function to provide support to the audit committee and the municipal manager (National Treasury, 2006:124). Internal audit has been regarded as a proponent of good governance (Motubatse, 2014) in that its role (as mandated by the MFMA) is to improve the organisation's performance and serve as an objective and independent resource to other governance functions (Asare, 2009:15). Thus, many public sector organisations have successfully integrated internal auditing into the organisation, as it is a cornerstone of good public sector governance and improves accountability and transparency, thereby increasing public confidence and reducing the risk of corruption (Christopher, 2015; Arena & Jeppesen, 2015; IIA, 2012; Jones & Beattie, 2015).

### **6.2.2.2 Risk management and governance**

Risk management is a process of understanding and managing the risks that the entity is inevitably subject to as it attempts to achieve its corporate objectives. For management purposes, risks are usually divided into categories such as operational, financial, legal compliance, information and personnel. One example of an integrated solution to risk management is the so-called enterprise risk management (ERM) approach (CIMA, 2010b). Local government, like any other public sector organisation, is facing challenges, changes and uncertainties. All these are called risks as they present unpredictable challenges. The constant flow of change seems to have become more complex and increasingly apparent in the everyday running of local government entities (PWC, 2010), requiring every organisation to develop and implement its own risk management strategy (Campbell, 2015; IRM, 2002). Risk management is an integral part of any organisation's strategic management (CIPFA, 2001; IRM, 2002). It is defined as the process whereby organisations methodically address the risks pertaining to their activities, with the goal of achieving sustained benefit within each activity, and across the portfolio of all activities (IRM, 2002:2).

In South Africa's local governments, the maintenance of effective, efficient and transparent systems of risk management is the responsibility of the accounting officer (RSA, 2003). Constitutionally, local governments in South Africa are viewed as the most appropriate institutions to deliver services to the communities. Notwithstanding this view, events such as service delivery risks, financial risks and political risks often materialise and adversely affect the local government's objective of service delivery (National Treasury, 2014).

According to PWC (2010) the challenges listed above can affect local governments as they manifest as service delivery disruptions, and inept financial planning, and these situations damage the reputation of individual municipalities and often the whole sector. Thus, the King III Report on Governance (IOD, 2009) requires governance structures such as municipal councils and their audit committees to have ensured that risks facing the local government entities are identified and adequately addressed. It is within this context that management must take responsibility for managing risks (CIPFA, 2001; IOD, 2009; United Nations, 2012).

Arising from the definition of risk management in the preceding paragraph, CIPFA (2001) identifies the objectives of risk management to include the following: protect the quality of service delivery; protect the reputation and image of the local government; safeguard the resources of the local government; secure and use the conditional grants efficiently; secure the well-being of employees and the service delivery recipients; avoid financial loss through fraud and corruption; consider and evaluate opportunities for divisional units to undertake new and to complete existing projects; consider the risks involved with outsourcing services and contract management; and manage change in leadership, politics, organisations and technology. According to CIMA (2010b), risk management is at the centre of any effective organisational strategy. It is a process that needs an approach that coordinates the efforts of all parties.

Risk management is the practice of identifying and analysing the risks associated with the business and, where appropriate, taking adequate steps to manage these risks (IOD, 2009:73). Owing to the nature of effective governance in organisations, risk management is seen as an integral part of governance (Subramaniam, et al. 2009; Drew, et al. 2006; IOD, 2009). As Bromiley, et al. (2015:265) state, all organisations are faced with risks and it is required that all organisations measure and manage those risks (Quon, et al. 2012). Arguably, as risks threaten to materialise the organisations' governance functions are moved out of their comfort zones (Bhimani, 2009; Spira & Page, 2003). As a result, it is essential that governance ensures that effective controls are in place to manage those risks (Subramaniam, et al. 2009; Spira & Page, 2002).

Nahar, et al. (2016) have investigated the association between risk governance and organisational performance. Their results show that there is a significant positive relationship between risk governance and the organisation's performance. Yudianti and Suryandari (2015) also confirm the positive link between governance and risk management. Hutchinson, et al. (2015) are of the opinion that such an association depends on the organisation's risk management policy, while Renn (2015) adds that, since risk management includes uncertain outcomes that affect the risk policy-setting process, it is important to integrate the process of risk management into the risk policy-setting process. Therefore, in the local government context, the council as

ultimately responsible for governance in the municipality, is expected to ensure that there is an effective risk management plan and associated processes in place.

The importance of risk management as a driver of effective governance has been acknowledged as a way to help organisations achieve their objectives (Subramaniam, et al. 2009:317). Its contribution to effective governance (and thus to the organisation's ability to achieve its stated objectives), is dependent on an improved understanding of the key risks faced by the organisation, and their wider implications; the identification and sharing of cross-business risk information; management's support on the issues that really matter; intensified focus on doing the right things in the right way; and more informed risk-taking and decision-making (IIA, 2009). While risk management was identified by Subramaniam, et al. (2009) and Drew, et al. (2006) as the responsibility of "everyone within the organisation," the King III Report (IOD, 2009) recognises that it is the board of directors that should ultimately be responsible for the governance of risk and its disclosure, while management should be responsible for the design and implementation of risk mitigation efforts, and for monitoring outcomes.

Accordingly, Drew, et al. (2006:137) identify additional key issues associated with the governance of risk. Amongst these are: the need to understand the risks the organisation is facing; the transformation required to bring about changes in the strategic risk exposure, and the programme implemented to manage strategic risks. However, as Subramaniam, et al. (2009:329) have noted, it is the risk committee that has the responsibility to ensure that risks and opportunities are identified. This also requires that the audit committee (as part of the governance structure), takes responsibility for the oversight of risk management (Brown, et al. 2009). Therefore, Subramaniam, et al. (2009:239) assert that it is the audit committee that should review the organisation's risk profile, and assess the operational risks and business risks.

### **6.2.2.3 Audit committee and governance**

Audit committees are established to provide oversight of the quality of financial reporting (Brennan & Kirwan, 2015; Inaam & Khamoussi, 2016; Zaman & Sarens,

2013; IFAC, 2014; Lisic, et al. 2015; Subramaniam, et al. 2009). Thus, the audit committees in local government are viewed as governance structures that enhance and strengthen financial management through promotion of the independence, integrity and effectiveness of audit activities (IOD, 2009). According to Morrell and Kopanyi (2014:270), it is important to establish an audit committee to work with the independent auditors and to review their reports. In the South African local government context, an audit committee is recognised as a proponent of good governance (National Treasury, 2014), and the roles and responsibilities of the audit committee are determined in terms of section 166 of the MFMA (RSA, 2003). These responsibilities include advising the municipal council on matters relating to: internal financial control and internal audits; risk management; accounting policies; the adequacy, reliability and accuracy of financial reporting and associated information; performance management; effective governance; compliance with the Division of Revenue Act, and with all other legislation; performance evaluations; and any other issues referred to it by the municipality or local government entity (RSA, 2003). Thus, the audit committee is expected to advise and also to report to the council on issues faced by the local government's control mechanisms, risks, and all significant audit findings raised by both internal and external auditors (AGSA, 2011/12).

In order to better understand the role and responsibilities of the audit committee, IFAC and CIPFA (2014) highlight the following key activities:

- helping to improve the adequacy and effectiveness of risk management and internal control;
- promoting the principles of good governance and their application to decision making;
- overseeing internal audit and supporting the quality of its activity, particularly by underpinning (championing) its organizational independence;
- reinforcing the objectivity and importance of external audits and, therefore, the effectiveness of the audit function;
- raising awareness of the need for sound risk management and internal control, and the implementation of recommendations by internal and external audit; and

- helping the entity to embed the values of ethical governance, including implementation of effective arrangements for countering fraud and corruption.

An audit committee is expected to play a role in improving the audit quality (Brennan & Kirwan, 2015; Inaam & Khamoussi, 2016; Zaman & Sarens, 2013; IFAC, 2014; KPMG, 2014a). Such quality improvement expectations require that it does more to ensure the accuracy and completeness of financial reporting, as it considers the auditor's plan and time, the audit processes, and the comfort of both management and the auditors when conducting open discussions about each other's activities.

The audit committee is a governance group which is independent from the executive management and the board of the entity, and is charged with oversight of the adequacy of the risk management effort, the effectiveness of internal controls and the integrity of financial reporting (IFAC & CIPFA, 2014:36). The audit committee is responsible for the quality of financial reporting and the audit processes of both internal and external auditors (Brennan & Kirwan, 2015; Inaam & Khamoussi, 2016; Zaman & Sarens, 2013; IFAC, 2014).

Since the auditors do not have a direct governance responsibility, except for providing an evaluation on the aspects of governance systems, the role of the audit committee fits between those of the auditors and governance. Accordingly, Boyle, et al. (2015:110) argue that the audit committee does play an important role in governance, and is in fact considered a champion of relationships in governance (Brennan & Kirwan, 2015). The audit committee enhances governance by providing detailed information about financial reporting, and also by helping the governance functions to understand financial statements (Inaam & Khamoussi, 2016). In addition, Rupley, et al. (2011) have noted that the understanding of financial reporting helps the audit committee to effectively review both internal and external reports. Thus, audit committee members oversee the conduct of internal and external audits, internal and external auditors oversee the conduct of management, and management has opportunities to express their views on the performance of the external auditors and audit committee members (Brennan & Kirwan, 2015:480). Although the audit committee's effectiveness has been examined in various ways, Rupley, et al. (2011) point out the characteristics of an effective audit committee are

derived from its composition, resources, authority and diligence. In evaluating the effectiveness of audit committees, Dezoort (1998) also recognises the importance of the experiences and relevant technical competences of the committee members.

Audit quality is measured by various factors, including the way in which the audit committee (both as a unit and as individuals) interacts with those entrusted with performing the various audit activities (Zaman & Sarens, 2013). Hence, as Inaam and Khamoussi (2016) points out, the effectiveness of the audit committee enhances audit quality. Thus, while the concept of audit quality does not have a formal definition from the International Auditing Standards (IFAC, 2014), considered in the light of the potential effectiveness of an audit committee explained in the preceding paragraph, the audit committee does influence the audit quality in a number of ways: chief among the contributions are that it fosters independence, financial literacy, experience, commitment and regular meeting with management and other stakeholders (Kalbers & Fogarty, 1993; Dezoort & Hermanson, 2002).

According to IFAC (2014) audit quality in relation to the quality and usefulness of communications with those charged with governance may be valued if it provides unbiased insights regarding the performance of management in fulfilling its responsibilities for the preparation of the financial statements; insight into the entity's financial reporting practices, including the operation of internal controls; recommendations for improvements to the entity's financial reporting process; and information that enables them to effectively fulfil their governance responsibilities.

A strong audit committee enhances audit quality (Gotti, et al. 2012). Audit quality may be measured in terms of the strength, competencies and the effectiveness of the audit committees. As expected, the audit committees in many organisations provide a competitive advantage by virtue of the depth of their skills, technical knowledge and other expertise they bring to their review of the work performed by the auditors, management and other service providers. Audit committees are also expected to enhance audit quality by ensuring that audit results meet investors' needs and that their reviews of the financial statements, including related disclosures, assurance about internal controls and going concern warnings are clearly and accurately communicated (Deloitte, 2014). Therefore, the audit

committee, as a tool of governance tasked and especially competent to interrogate the audit processes and auditors methodologies, may well be instrumental in enhancing the quality of the audit.

Interestingly, a study conducted by Van der Nest, et al. (2008) into the relationship between audit committees and accountability in the South African public sector, concludes that the audit committees are being effective in improving governance, and they are performing well in their task of reviewing the work of external auditors in public sector organisations. This confirms Deloitte's (2009) recognition that the audit committee has a functional responsibility to oversee the external audit processes. This study argues that for the audit committee to ensure a quality audit outcome, they must state their opinion as to whether the auditor was independent, and also comment on the financial statements, accounting practices and internal financial control measures of their local government entities. In South Africa's local governments, the audit committees' areas of authority and responsibility are defined by the terms of the Municipal Finance Management Act. These responsibilities are detailed in section 166 of the MFMA, and include the areas of: internal financial control and internal audit; risk management; accounting policies; the adequacy, reliability and accuracy of financial reporting and information; performance management; effective governance; compliance with the MFMA, the Division of Revenue Act and any other applicable legislation; performance evaluation; and any other issues referred to it by the municipality or municipal entity (RSA, 2003). They are also required to operate in accordance with professional best practices and the National Treasury Regulations.

In view of the fact that the audit committee is an important tool of governance with the ability to improve audit quality, Deloitte (2012) outlines what is expected of the audit committees and their levels of financial expertise. Members of an audit committee must have an understanding of the entity's financial statements and reporting frameworks; be able to assess the application of reporting frameworks in connection with accounting for estimates, accruals and reserves; have experience in the preparation of financial statements, understand how auditing is performed; an ability to evaluate financial statements that present the full breadth and depth of



complexity of accounting issues in the public sector, and an understanding of auditing procedures for financial reporting.

- ***Independence***

Their independence allows the audit committee to challenge management decisions freely and objectively (KPMG, 2009). According to Al-Matari, et al. (2014), the independence of the audit committee contributes positively to the achievement of good governance, confirming that the audit committee is a potentially key contributor to the achievement of good governance in the local government environment (IOD, 2009). Various researchers have emphasised the fact that the independence of the audit committee is key to its effectiveness (Zaman & Sarens, 2013; De Vlaminck & Sarens, 2015; Al-Matari, et al. 2014; KPMG, 2009).

IFAC and CIPFA (2014) identify the audit committee as another source of assurance in governance and that its independence is important to enhancing governance (Rupley, et al. 2011; Boyle, et al. 2015; DeZoort, 1998; De Vlaminck & Sarens, 2015). In view of the fact that the audit committee needs to demonstrate its effectiveness, IFAC and CIPFA (2014) make several recommendations of which the most important is that the audit committee's effectiveness depends on it being independent of both executive management and directors. It plays its role in helping to improve the adequacy and effectiveness of risk management and internal control; promoting the principles of good governance; overseeing internal audit and supporting the audit quality; reinforcing the objectivity and importance of external audits; raising awareness of the need for sound risk management, internal control and the implementation of recommendations made by internal and external audit; and also in helping to promote the values of ethical governance (De Vlaminck & Sarens, 2015; IOD, 2009; IFAC & CIPFA, 2014).

The auditors, on the other hand, are expected to demonstrate their independence from governance structures in order to enhance audit quality. But, while Jamal and Sunder (2011) associate the auditor's independence with audit quality, Daniels and Bookers (2011) feel that the auditor's independence may not of itself enhance audit quality. Either way, independence requires the auditor to comply with the principle

that an auditor should not assume management's responsibilities in any business or operational capacity, nor perform an audit engagement in any areas in which he or she has a direct involvement or a recent direct involvement, and also resists being influenced by the client while in the service of the client. Thus, when the auditor's independence is maintained it is an important contribution to maintaining audit quality (Soltani, 2007).

- ***Financial literacy***

Financial literacy refers to the ability to read and understand financial statements. It is demonstrated by employment experience and certification in finance, accounting and other related services (Iyer, et al. 2013; KPMG, 2009). The financial literacy of the audit committee members is a prerequisite component of competence (IFAC, 2003; Iyer, et al. 2013). In fact, the most important part of the audit committee's competence is in its financial expertise (Abernathy, et al. 2015). The audit committee's financial expertise enhances audit quality (Deis & Giroux, 1996). Audit committee members with accounting expertise are better able to understand and assess accounting issues and determine appropriate resolutions (Abernathy, et al. 2015:7) than are their colleagues from different professional backgrounds. The audit committee, as part of governance, demands a higher level of competence in financial literacy in order to understand the problems encountered in the financial reporting, and to identify the risks of misstatements and other accounting errors (Oktorina & Werdari, 2015). The financial literacy of the audit committee can be measured in terms of members' academic studies, their on-the-job training, work experience and professional education.

In his study of the audit committee members' characteristics, Aryan (2015) shows that there is no significant relationship between the fact of being an audit committee member and their individual (or collective) financial literacy. However, Abernathy, et al. (2015) investigated the association between the audit committee members' accounting expertise and financial reporting timeliness, and the results show there to be a positive relationship with financial literacy. These results further suggest that the audit committee's effectiveness may be improved by appointing members who have formal financial or accounting training and experience (Abernathy, et al. 2015).

- ***Experience***

Audit committee effectiveness is measured by their experience (Iyer, et al. 2013). Such experience includes knowledge of the industry's operations, accounting knowledge, and management principles (Hoitash, et al. 2013). An understanding of business risk, controls and applicable accounting policies are also deemed important (KPMG, 2009).

Despite the fact that financial literacy is identified as an essential skill of an effective audit committee member, it does not necessarily mean that all members of the audit committee should be skilled in accounting and finance. Other skills such as law, risk management, information technology and other technical fields are also pertinent contributors to the creation of an effective audit committee (IOD, 2009; KPMG, 2009). Utilising their collective competence in these various disciplines, the audit committee is expected to facilitate efficient and effective cooperation in governance (Alabede, 2012; Nyman, et al. 2005).

An audit committee with appropriate experience is likely to enjoy enhanced efficiency and also be able to resolve any conflicts that may arise between management and auditors (Abernathy, et al. 2015). Interestingly, Iyer, et al. (2013) used a regression model to examine the characteristics of the financial expertise and qualifications of the audit committee members, and the results of the analysis show that the audit committee's experience is positively regarded by the rest of the governance providers. Albring, et al. (2013) came to similar conclusions, also suggesting that the experience of the audit committee does impact on their ability to contribute to effective governance.

Various publications reviewed for this research use the term competency in place of experience, for various reasons (Siriwardane, et al. 2014; Glover & Prawitt, 2014; Leung, et al. 2009). These terms can be understood as synonymous with skill (Arens, et al. 2014), knowledge (Leung, et al. 2009) and the ability to perform certain tasks (Siriwardane, et al. 2014; Glover & Prawitt, 2014). In South Africa, competence is the term used almost exclusively with reference to hiring, training, qualifications,

skills and any other form of evaluation and assessment. According to IFAC (2006:20):

*“competence refers to the demonstrated ability to perform relevant roles or tasks to the required standards, whereas capability refers to the attributes held by individuals that give them the potential to perform. Competence refers to the actual demonstration of performance. Competence may be assessed by a variety of means, including workplace performance, workplace simulations, written and oral tests of various types and self-assessments.”*

Siriwardane, et al. (2014), in their study of skills, knowledge and attributes, reveal that the demonstration of professional competencies is an important component of audit quality, whereas Glover and Prawitt (2014) conclude that competency enhances audit quality through professional identity, communication and practices. In order to maintain the audit quality, and extrapolating from the above descriptions of competence, Glover and Prawitt (2014) simply remind auditors to adhere to professional standards. Thus, the auditors should apply their proficiency throughout the audit, and the auditor's competence is then evidenced in the quality of the audit (Favere-Marchesi, 2000). Leung, et al. (2009) also argue that competence is a characteristic of a professional person, and therefore, when the auditor faces pressure from management or a time constraint, the audit quality should nevertheless not be compromised. Despite the term competency having been used in various ways and forms, this study argues that there is an overarching view of competency among the auditors as a descriptor for their technical experiences and ethical behaviour, and the professional qualities expected to be upheld at all costs.

- **Commitment**

Commitment is one of the fundamental qualities present in an effective audit committee. According to Ahmed (2016:1), commitment has a significant effect on the efficiency and the success of the individual teams of workers and the organisation as a whole. Thus, the audit committee's commitment is reflected in the effectiveness of the audit committee (Ika & Ghazali, 2012). Such effectiveness is additionally associated with an employment position, a profession, and with career success

(Ahmed, 2016:2). According to Martinov-Bennie, et al. (2015), the effective functioning of the audit committee requires commitment and competent performance evaluations. Usually such evaluations are expected to be done by the senior management, internal auditors and external auditors (Martinov-Bennie, et al. 2015; National Treasury, 2009). Such a performance evaluation should be done timeously and objectively in order to enhance the commitment and effectiveness of the audit committee.

Active involvement of the audit committee in the activities of auditors and governance show the commitment of the audit committee. Morgan (2010) states that the duties and functions of the audit committee require commitments of time and effort in order to execute their responsibilities effectively. The use of an audit committee charter is another formal, mandatory compliance-driven measure of the commitment and effectiveness of the audit committee (National Treasury, 2009; Ika & Ghazali, 2012). Enhancing the level of commitment of the individual members is an important way to enhance the effective functioning of the audit committee.

- ***Regular meeting***

Regular meetings (as required in say an audit committee charter) indicate a focused, relevant and efficient audit committee (KPMG, 2009). A regular meeting of the audit committee is another form of accountability and supportive of good governance and of stakeholders' interests. The audit committee meetings are associated with time management and audit committee effectiveness (Ika & Ghazali, 2012). Hence, an effective audit committee is often measured in terms of the number of meetings they have attended with management, internal auditors, external auditors and other assurance providers. Another measure of the effectiveness of the audit committee in governance matters relates to the number of pertinent issues discussed, as opposed to the routine-type agenda items that form the backbone of their regular meetings (Jan, 2015). Therefore, the content and quality of discussion at audit committee meetings are indicators of the effectiveness and accountability of the committee, and of compliance with the audit committee charter. It should be noted that the Municipal Finance Management Act clearly stipulates that the effectiveness of the audit committees should be measured against their charters (RSA, 2003).

Meeting regularly enables the audit committee to stay on top of the issues that are affecting, or are likely to affect, governance and audit quality, and on the outcomes. Aryan (2015) ran a multiple regression analysis on the characteristics of the audit committee and the results show the existence of a positive relationship between the frequency of audit committee meetings and the entity's size and profitability. These results are also confirmed by Li, et al. (2012) who found that the size and frequency of meetings are positively associated with the characteristics of an effective audit committee.

### **6.3 SUMMARY OF THE CHAPTER**

Chapter 6 discussed the literature on municipal governance and audit outcomes. The municipal governance function is made up of the municipal manager (who is the head of administration), the mayor, municipal council, municipal public accounts committees and also the internal audit function, risk management function and the audit committee. In South African local governments, effective governance is still a challenge as a result of political infighting, which affects the administrative running of the municipalities, and in turn brings about poor audit outcomes and non-compliance with legislative frameworks. These outcomes then affect the audit quality. Therefore, this indicates that an effective governance function requires tools such as those provided by internal audit, risk management and the audit committee in order to enhance audit outcomes in the local government sector. Such demonstration of good governance requires respect for the rule of law, and adherence to entity policies and procedures. The next chapter discusses the research method used in this study.

## **CHAPTER 7**

### **RESEARCH METHODOLOGY**

#### **7.1 INTRODUCTION**

This chapter presents the research design and methodology used to test the research questions outlined in Chapter 1 of this study. The chapter also explains and justifies the methodology chosen for the investigation of factors affecting progress towards the desired 'clean audit' outcome in South Africa's municipalities. The chapter then outlines the specific model and control variables used in this study. Finally, a summary of the chapter is provided.

#### **7.2 RESEARCH METHOD AND DESIGN**

Gray (2009:131) defines research design as "the overarching plan for the collection, measurement and analysis for data". Research design presents the plan or blue-print detailing how the study should be conducted in order to achieve the stated objectives (Babbie & Mouton, 2010:74). Gray (2009) further indicates that the research design describes the techniques to follow in collecting data, how the sample is to be selected and how the data is to be analysed. Creswell (2013b:12) describes research design as a type of inquiry within quantitative, qualitative and mixed methods approaches that provides specific direction for research procedures. Hence, it refers to the overall strategy that the researcher chooses to employ to integrate the different components of the study.

The first step in determining an appropriate research design requires that the researcher identify his/her research's 'world view', usually referred to as the research paradigm (Babbie & Mouton, 2010). McGregor and Murnane (2010:419) define the research paradigm as a set of assumptions, concepts, values and practices that collectively constitute a way of viewing reality. There are two major types of research paradigm: positivist and non-positivist. Kaboub (2008:343) records that positivism emerged as a philosophical paradigm in the 19<sup>th</sup> century in support of efforts to measure the relationship between two variables. Thus, positivists aim to test a theory

through observation and measurement in order to predict and control the factors that influence its surroundings (O'Leary, 2004:5). Kaboub (2008:343) states that within the positivist paradigm, real events can be observed and explained logically through analysis. Stahl (2007:4) defines positivism as a research paradigm which is based on the ontological doctrine that the reality is independent of the observer. While the ontological assumptions form the most important building blocks of how the world is being viewed (Stahl, 2007:4), it is for this reason that Aliyu, et al. (2014) associate the positivist paradigm with quantitative research. As a result, Alessandrini (2012) explains that the positivist favours quantitative data, while the non-positivist favours qualitative data. Thus the present study is more amenable to the positivist paradigm for its determination, objectivity, quantification, reliability and support of generalisation (Broom & Willis, 2007:22). The present study uses a secondary source of information, and Broom and Willis (2007:22) recognise that the use of secondary data also fits the positivist paradigm. In this study, the advantage of using the positivist paradigm to answer the important research questions about the effect of leadership, financial management and governance with the audit outcome lies in its preference for observable facts, rather than opinion and speculation.

Despite this researcher's preference for the positivist approach in research (supported by Aliyu, et al. 2014), who posit that positivism is particularly influential in research), Alessandrini (2012) explains that there is an alternative in the form of non-positivism, a school of thought which rejects the positivist ideology. Non-positivism has emerged in reaction to the dominance of the positivist approach (Alessandrini, 2012): non-positivists recognise that data collected through a positivist approach, such as empirical data, can be rendered invalid precisely because of its positivist treatment that includes the avoidance of opinion and speculation (Alessandrini, 2012). Hence, it can be used in qualitative research paradigm (Aliyu, et al. 2014).

Krauss (2005:767) explains that a quantitative research paradigm reflects positivist views about the nature of reality. In line with these views, Babbie and Mouton (2010:49) also indicate that quantitative research is concerned with positivism. Positivism is a dominant paradigm in social science research at present, with a well-organised method for combining deductive design and empirical observation



(Neuman, 2011:95). Msweli (2011:58) supports this view, observing that a deductive design is also used when asking the research questions “where,” “how many,” “how much” and “to what extent...”. Msweli (2011:60) goes further, indicating that deductive design allows the theoretical concepts to be measured before empirical investigation is undertaken. Therefore, remaining within the research paradigm, Babbie (2013:4) stresses that a research methodology involves the systematic processes which a researcher uses to resolve the research problem. Of course, a methodology is a system of methods used for finding out something, or the use of preferred procedures for a particular (usually scientific) investigation (Rajasekar, et al. 2006).

- ***Causal research design***

Brewer and Kubn (2010) explain causal research design as a type of research used to measure the effects of specific assumptions. It deals with effects and variables (Shadish, et al. 2002), and how they relate to each other (Brewer & Kubn, 2010). Fraenkel, et al. (1993) define causal research design as a research construct that attempts to determine the causes and effects of existing differences between selected variables. Brewer and Kubn (2010) add that this design type is used when the variables lead to a particular result. Therefore, a causal research design assists the researcher to understand *why* the world works the way it does through the process of providing causal links between variables X and Y (Brewer & Kubn, 2010). With causal research design, the researcher is able to identify the cause of the effect, whether the cause is related to the effect, and whether (and degree to which) the variables are related (Shadish, et al. 2002).

Referring to quantitative research methods, Neuman (2011:174) identifies the characteristics of quantitative research as the ability to test the study’s research questions; to conceptualise the variables, and also to measure the data collected in the form of numbers and statistics. According to Creswell (2003:13), a quantitative approach employs strategies of inquiry such as experiments and collecting data using predetermined instruments that yield a matrix of statistical data. Babbie (2010) explains that quantitative research presumes that there is an objective to study, that there is a research problem to investigate, and an obligation to control and measure

the data. In this research, quantitative data is used to investigate the relationships between leadership, financial management, governance and audit outcomes in South Africa's local governments.

### 7.2.1 Research area

The geographic research area for this study includes all the municipalities in the Republic of South Africa. Figure 7.1 below shows the research area, being the municipalities in all nine provinces in South Africa. The source of the data used in this study has been extracted from the AGSA's annual audit reporting for each province for the financial years 2009/10 - 2013/14.

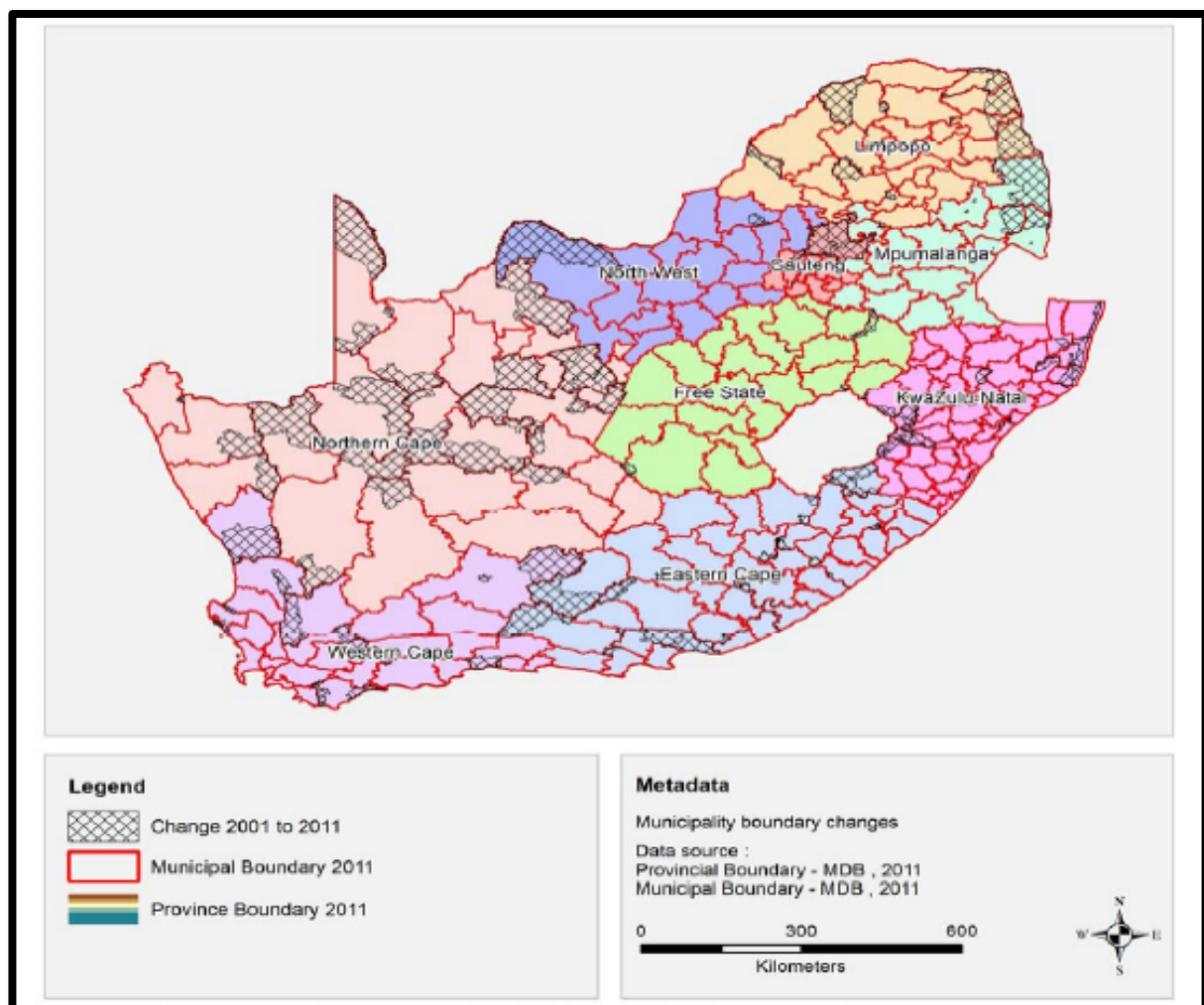


Figure 7.1: Location of South African municipalities (Source: Statistics South Africa, 2011)

## **7.3 POPULATION AND SAMPLE**

This subsection discusses population and sampling technique and research sample.

### **7.3.1 Population**

Research population is defined as the total number of items about which the researcher wishes to draw a conclusion (Degu & Yigzaw, 2006; Banerjee & Chaudhury, 2010; Lengerer, et al. 2012). The population for this study is all the municipalities in all the nine provinces of the Republic of South Africa. The studied population has been reported on in the AGSA's local government audit outcome reports from 2009/10 to 2013/14.

### **7.3.2 Sampling technique and research sample**

Latham (2007) explains sampling as the need to take a representative selection from the population, usually because the population is too large to investigate as a whole. Thus, the need to sample (if present) influences the researcher's choice of suitable data-gathering method. There are two categories of sampling method in widespread use: these are probability and non-probability (Fox, 2010; Babbie, 2013). Probability sampling is sometimes called random sampling, while non-probability sampling is sometimes called non-random sampling (Latham, 2007). For the purposes of this study, a non-probability sampling method was used. It is considered to be appropriate where the research does not require representativeness of the population (Babbie, 2013; Latham, 2007).

Non-probability sampling is appropriate when the study attempts to answer a particular research question (Berzofsky, et al. 2013; Latham, 2007; Fox, 2010; Babbie, 2013). Non-probability sampling employs various methods, including purposive and convenient sampling (Babbie, 2013; Fox, 2010; Latham, 2007). Purposive sampling is also known as judgmental sampling (Babbie, 2013; Leedy & Ormrod, 2013). Purposive sampling is used when there is a deliberate purpose requiring information from specific informants in a research project (Tongco, 2007). Leedy and Ormrod (2013) add that purposive sampling is suitable for readily

available information. It may be used with both qualitative and quantitative research techniques (Leedy & Ormrod, 2013; Tongco, 2007).

Researchers use purposive sampling (Latham, 2007) when it is necessary to select cases that are judged to possess similar characteristics (Tongco, 2007; Babbie, 2013). Convenience sampling is used where participants are selected based on proximity to the researcher and accessibility, willingness to participate in the study or other such non-statistically defined reasons (Babbie, 2013). For this study it was deemed necessary to pursue purposive sampling technique. The database, the AGSA's audit reports on all municipality audits for the financial years from 2009/10 to 2013/14, was deemed sufficiently to be analysed in its entirety, as a single unit.

#### **7.4 DATA COLLECTION PROCEDURES**

This section details the methodology for data collection, which, in this research is documentary or secondary archival data. Leedy and Ormrod (2013) explains that data collection begins after the research problem has been identified and the research design described. Babbie and Mouton (2010:76) explain data collection as the assembly of numerical data for quantitative research, or textual data for qualitative research (Flick, 2011:11-12). Thus, data is empirical evidence or information carefully collected in accordance with the needs of the procedures dictated by the research (Neuman, 2011:9). This study collected pre-existing (or secondary) data. Hox and Boeije (2005:593) describe secondary data as “data originally collected for a different purpose and reused for another research question”.

Secondary data are thus data collected by others for their specific purposes, and made available through books, libraries and websites to a wider audience of researchers (Diamantopoulos & Schlegelmilch, 2004:5; McCaston, 2005:2; Adams, et al. 2014:104), Such data includes information relating to government surveys and administrative records (Remler & Van Ryzin, 2011:533; McCaston, 2005), which were originally organized to achieve other objectives (Hox & Boeije, 2005; Doolan & Froelicher, 2009; Johnston, 2014). McCaston (2005) explains that secondary data “with a research orientation” is widely sourced from research information collected by governments or large institutions. For this research, the secondary data came from

the publicly available data on the AGSA's website. It includes the audit outcomes reports from the 2009/10 to 2013/14 municipal financial years. According to Walliman (2005:242), once a source of data is identified it can then be subjected to interpretation.

Justification for the use of secondary data is that it enables the researcher to 'skip the grind-work', and concentrate on essential data analysis and interpretation (Adams, et al. 2014:105). According to Adams, et al. (2014:106), a researcher should justify why a secondary data source is relevant to their efforts to address the research questions. Johnston (2014) agrees: the decision to use secondary data must emerge from its ability to address the research problem, and the researcher's assessment that the data fits the research aim. Thus, as this research's aim is to examine the factors affecting progress to 'clean audit' status in South Africa's municipalities, using the Auditor General South Africa's audit outcomes from 2009/10 to 2013/14 South African local government audits is supported by the authority of the AGSA's mandate. This secondary data is therefore the most appropriate source of data to answer the research question, primarily because of the consistency of its collection over a long period of time (Doolan & Froelicher, 2009:205).

Secondary data was also chosen as a data source for this research as it reduces the data collection time (Doolan & Froelicher, 2009:214; Windle, 2010:323). It can be carried out in a significantly shorter period than is possible when collecting primary data (in this instance, a 15 minute download of data compared with the 6 years needed to prepare and collect the audit reports) (McCaston, 2005). The existing data can be analysed and replicated from different perspectives, and its (re-)use also provides the opportunity to discover relationships not previously considered in the primary research (Smith, 2008:328). According to Kimberlin and Winterstein (2008:2282), "the first consideration for deciding whether secondary data can be used [or not,] is to verify that the data is set appropriately to measure the variables required to answer the research questions". If the second set of research questions can be adequately addressed, the secondary data can be a valuable source of information, knowledge and insight into a broad range of issues and phenomena (McCaston, 2005).

#### **7.4.1 Research data**

Research data is data that is collected, observed, or created for purposes of enabling analysis that produces original research results (Creswell, 2013b; Babbie, 2013; Leedy & Ormrod, 2013). The research data for this study was derived from the AGSA's annual assessments of audit outcomes. The specific research data are the key drivers of internal control; these include leadership scores, financial management scores, governance scores and the scores on 'clean audit' outcomes for South African municipalities in the nine (9) provinces of South Africa. These key scores were used to evaluate their effects on the audit outcomes (See Annexure A: Key drivers of internal control; Annexure B: Tools of governance, and Annexure C: Clean audit outcomes).

### **7.5 DATA ANALYSIS PROCEDURES**

According to Li, et al. (2011:387), the use of panel data analysis has received attention over the last few decades due to its effectiveness in addressing research issues in many disciplines, including economics and finance. It has also become an important analysis tool in the field of public administration and other fields of socio-economic research (Sarafidis & Wansbeek, 2012). Panel data analysis is also called longitudinal data analysis (Hsiao, 2007; Yaffee, 2003). It contains time series data and observations conducted over a number of activities (Hsiao, 2007) that is periodically surveyed over a given time span (Yaffee, 2003). Thus, within a social sciences context, a panel data analysis enables the researchers to undertake longitudinal analysis (Yaffee, 2003).

In this study, the panel data used has been extracted from the Auditor-General's reports from the financial periods 2009/10 to 2013/14. The panel data set consists of local governments across the country, and comprises data on the variables of clean audit opinion, leadership, financial management and governance. In this study, the number of time periods available was fixed – determined by the period initially deemed sufficient for municipalities to all achieve 'clean audit' status. It is important to note that these variables (clean audit opinion, leadership, financial management and governance) do not follow clearly defined paths to success or failure, either

when compared against peers within a province, or across provinces, or over the time frame. While some municipalities indicated improvements in some of the variables, others are regressing, almost all failing to achieve or sustain a 'clean audit' opinion during the period. There was no need to sample the data as the data set was sufficiently small to allow the use of a census approach. Adams, et al. (2014:105) warn that often the secondary data has been aggregated to a regional or even a national level, rendering it of lesser use to researchers in need of data for smaller units of analysis. The data set provided by the AGSA's reports retained sufficient detail, despite some aggregation, to fit the purpose of this research project.

Data analysis based on the secondary data in this study was guided by the causal research design discussed in section 7.2 above and was statistically investigated to determine the cause-and-effect relationships that existed between leadership, financial management, governance and the achievement of 'clean audit' outcomes.

### **7.5.1 Multiple regressions**

Regression analysis was used as to analyse the data (generated from the primary data source) to determine the correlation or relationship between the achievement of a 'clean audit' outcome and the independent variables (leadership, financial management and governance). A multiple regression analysis is used to determine the correlation between a criterion or variable and a combination of two or more other variables (Babbie, 2013:467). This regression model is concerned with finding relationships between a number of variables and can be expressed in the form of an equation (Adams, et al. 2014:202; Babbie & Mouton, 2010:646). Bryman and Cramer (2011:296) report that using multiple regressions is vital if the research has more variables. This study therefore uses multiple regressions as it involves multiple variables, namely achievement of 'clean audit' outcomes, leadership, financial management and governance. According to Babbie and Mouton (2010:464), the *general formula* for describing multiple regressions is:

$$y = a + b_1 x_1 + b_2 x_2 + e$$

Thus, this general formula can be rewritten to accommodate the number of variables in a study. This study has three independent variables, namely leadership, financial management and governance, which are known to have an influence on the dependent variable, the achievement of a 'clean audit'.

Whereas, the achievement of a 'clean audit' remains the dependent variable, the independent variables are analysed to make predictions about how and why local governments in South Africa have been progressing (or regressing) in their efforts to achieve 'clean audit' opinions in the period 2009/10 - 2013/14.

The multiple regression model is presented thus:

$$Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \varepsilon$$

Where:

<p>Y = level of clean audit achieved (shortened as: <b>CLAud</b>)</p> <p><math>\beta_0</math> = constant (Y intercept)</p> <p><math>\beta_{1-3}</math> = intercept (regression coefficient)</p> <p><math>x_1</math> = level of good leadership (first predictor) (shortened as: <b>Led</b>)</p> <p><b>Control Variables:</b></p> <p><math>x_2</math> = financial management (second predictor) (shortened as: <b>FinMgt</b>)</p> <p><math>x_3</math> = Governance (third predictor) (shortened as: <b>Gov</b>)</p> <p>e = error = 0</p>
---

The model can thus be rewritten as:

$$\hat{CLAud} = \beta_0 + \beta_1 * Led + \beta_2 * FinMgt + \beta_3 * Gov$$

From the above formula it can be explained that Y represents the predictor value, which is a dependent variable (clean audit), and the  $X_1$  value represents independent variable 1 (leadership),  $X_2$  represents independent variable 2 (financial management) and  $X_3$  represents independent variable 3 (governance).

The formulation of the research question and the associated objectives were used as research instruments to find out what was needed to achieve a 'clean audit'. The following research questions (first stated in Chapter 1, sections 2 and 3) were used



to conceptualise the study, and are specifically addressed by the multiple regression model presented above:

- How does leadership affect the achievement of a 'clean audit' outcome?
- How does financial management affect the achievement of a 'clean audit' outcome?
- How does governance affect the achievement of a 'clean audit' outcome?
- What possible framework might foster the achievement of 'clean audit' outcomes in a developing economy such as South Africa?

The specific objectives of the study included the following:

- to examine the effect of leadership on the achievement of 'clean audit' outcomes;
- to examine the effect of financial management on the achievement of 'clean audit' outcomes;
- to examine the effect of governance on the achievement of 'clean audit' outcomes; and
- to propose a guidance framework to assist in understanding the factors that affect progress to a 'clean audit' outcome in a developing economy such as South Africa.

## **7.6 RESEARCH VALIDITY**

"Validity is the strength of conclusions, inferences or propositions" (Adams, et al. 2014:247) arrived at on completion of the analysis and interpretation of the data. Since validity is used to measure the correctness of the results, research question and objectives, Babbie (2013:191) describes validity as a measure that accurately reflects the concepts it is intended to measure. Since the study focused on the measurement of factors helping or hindering the achievement of a 'clean audit' opinion, the extent to which validity is measured is represented by the roles of leadership, financial management and governance in the achievement of 'clean audits.' Thus, validity is concerned with the extent to which the research data is able to generate accurate information which is relevant to the research question. According to Adam, et al. (2014:274), validity is assessed in four categories, namely:

- *internal validity*, which seeks to determine the relationship between the programme and the outcome;
- *external validity*, which refers to the ability of the researcher to generalise or extrapolate the results of the study to address other data sets;
- *construct validity*, which seeks to determine the relationship between the concepts and what the study aims to achieve; and
- *conclusion validity*, which seeks to address the relationship between the programme and the observed research outcome.

## **7.7 RESEARCH RELIABILITY**

Neuman (2011:208) explains that the term reliability refers to a measure of dependability, and it deals with the consistency of the results of the analysis (Adams, et al. 2014:245). According to Babbie (2013:188), the issue of reliability is concerned with the quality of the measurement method, which requires that the same data would have been collected each time in repeated observations of the same phenomenon, in order to be judged reliable. Thus, the term reliability is commonly used by the auditors when evaluating their audit evidence obtained, and is influenced by the auditor's sources of information, the nature and the circumstances under which it is obtained, and includes the controls exercised over its preparation and preservation (SAICA, 2014/15 ISA 500 Para A31). Adams, et al. (2014:245) report that the most important element of reliability lies in the quality of the variables. This study has four variables, namely 'clean audit' opinion (independent), and leadership, financial management and governance (dependent variables), and their reliability and quality was determined to be reliable based on the consistency of the results.

## **7.8 ETHICAL CONSIDERATIONS**

Ethics in research helps to ensure that no research processes infringe on human rights, nor do they cause any kind of harm by revealing information of a confidential nature regarding the individual participants involved (Wisker, 2008). The University of Limpopo, like any other academic institution of higher learning enrolling students for postgraduate research programmes, is very particular about ethics in research.

As this study of the South African municipalities' progress towards 'clean audit', and obstacles experienced along the way did not make use of first-hand data collection techniques or direct (or electronic) contact between the researcher and office-bearers and employees in the country's municipalities who provided the information the AGSA used, no formal or conventional ethical procedures were deemed necessary. The study only used so-called desktop research tools, applied to data which was already publicly available on the AGSA's website. No information of a personal nature was made available by the AGSA, and such data as was contained in the reports on local government was also not readily identifiable with particular people or office bearers. Ethical considerations in research are of the utmost importance when people are involved and potentially individually identifiable. Using a secondary data source is an advantage in that it grants the researcher access to data without having to access or be exposed to personal information that might compromise an individual's confidentiality (Coyer & Gallo, 2005:62). Law (2005) asserts that the ethical concerns arising from the use of secondary data focus on the potential of the research findings to harm individuals behind the data being subjected to the research. Thus, as the researcher had no access to any of the AGSA's primary audit data, nor to the details of whom the auditors interviewed at the various municipalities, it was deemed that this study did not have any potential to affect, either positively or negatively, any of the individual human beings associated with the municipalities.

## **7.9 SUMMARY OF THE CHAPTER**

This chapter focused on the research design and the methodology applied in this study of factors affecting the achievement of 'clean audit' opinions in South African municipalities. The research design and methodology were discussed as these are the tools employed to achieve the research objectives. In the context of the research objectives, this chapter reviewed various aspects of research design and methodology that are used by various scholars in both quantitative and qualitative research approaches. A desktop research method was used in this research, made possible by the use of secondary data accessed on the AGSA's website. The objective was to examine the South African municipalities' progress in efforts to achieve, and obstacles encountered on their journeys towards the achievement of

'clean audits'. The research instruments, the limitation these posed on the study, and the research's ethical considerations were also discussed. The next chapter deals with the data analysis, interpretation and presentation of the results.

## **CHAPTER 8**

### **DATA ANALYSIS AND FINDINGS**

#### **8.1 INTRODUCTION**

This chapter presents the empirical analysis and the results of the regression analysis. This chapter thus addresses the five underlying research questions that drove this study in order to answer the main research question.

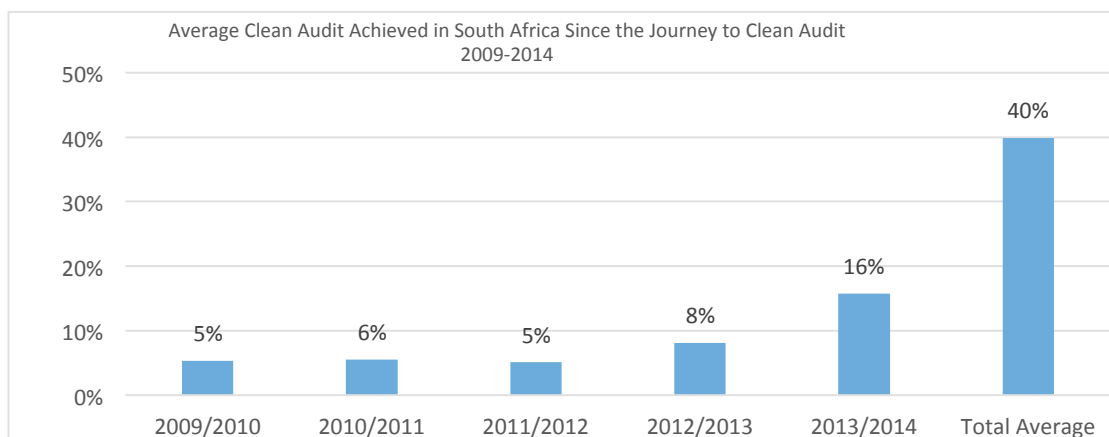
#### **8.2 ANALYSIS OF DATA**

Before proceeding with the analysis of the data on the factors affecting progress to 'clean audit', it is important to review the current state of South Africa's nine (9) provinces' abilities to achieve 'clean audits'. The results presented in the graphs below are derived from the Auditor General of South Africa's (AGSA) annual reports for the period 2009/2010 - 2013/2014. It should be noted that the AGSA consolidates the individual municipal reports into a single consolidated audit report for each province. The nine provincial consolidated reports formed the data pool for this and subsequent analyses. The somewhat inferior quality of audit outcomes achieved in South Africa's municipalities and shown in the graphs in Figure 8.1 provided the impetus to proceed with the analysis of the factors the AGSA judged to be drivers of progress to the achievement of 'clean audit' outcomes. The supporting data for Figure 8.1, the achievement of 'clean audits' by South African municipalities, is derived from data presented in Appendix 2.

The AGSA's journey to achieve clean audit opinions from all entities' audits across the public sector by 2013/14 financial reporting year end was the AGSA's contribution to the government's turnaround strategy on public financial management and accountability. Figure 8.1 indicates that the current rates of achievement of 'clean audits' is very low, and while the total is improving, it remains a major challenge faced by municipalities in all of South Africa's local governments.



**Figure 8.1: Achievement of 'clean audit' outcomes in South African municipalities 2009 - 2014 (Source: Graphs derived from author's analysis of data from various AGSA reports 2009-2014)**



**Figure 8.2: Average annual achievement of 'clean audits' by South African municipalities during the initial journey to clean audit campaign (2009 - 2014)**

Since Operation Clean Audit was initiated in 2009, the state of affairs has remained bleak as many provinces are still struggling to achieve any clean audit outcomes in any of their municipalities. Figure 8.2 shows the annual national averages of clean audits achieved for all nine (9) provinces. Although Figure 8.1 shows some progress towards the 'clean audit' goal, the progress has been very slow, with annual 'clean audit' achievement rates of 5%, 6%, 5%, 8%, and 16% for 2009/2010, 2010/2011, 2011/2012, 2012/2013 and 2013/2014 respectively. This indicates that as of 2014, the journey to achieve 100% 'clean audits' in all of the nine provinces was still way beyond current capacity and ability to achieve. That the total of clean audits achieved in 2013/2014 was 16% and that this is more than double the 5-year annual average of 8% and is an indication of progress, however slow. This gloomy rate of progress thus provided the impetus to proceed with the evaluation of the factors the AGSA identified as affecting (and effecting) progress to the achievement of universal 'clean audits'. In Chapter 3, three (3) factors were identified by the AGSA as able to bring about clean audits. These factors or drivers of clean audit outcomes are "... leadership, financial management and governance" (AGSA, 2014:1).

### **8.3 ANALYSIS OF RESEARCH QUESTIONS**

This section presents the statistical analysis of the data in response to the research questions. There are three major research questions that have driven this research, and these formed the basis of the literature reviews reported in Chapters 4, 5 and 6. Whilst the three major research questions were addressed based on the analysis of the panel data from the five years of municipal audit outcomes from the nine provinces, the fourth research question, the formulation of a guidance framework to assist in understanding the factors that affect progress to a clean audit, is the researchers' contribution to academic research. This fourth research question is addressed in Chapter 9 as part of the contribution of the research to the body of academic research.

The three main research questions, which will be analysed next, are:

**Research question 1:** How does leadership affect the achievement of 'clean audit' outcomes?

**Research question 2:** How does financial management affect the achievement of 'clean audit' outcomes?

**Research question 3:** How does governance affect the achievement of 'clean audit' outcomes?

**The multiple regression model:**

$$Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \varepsilon$$

Where:

Y = level of clean audit achieved (shortened as: **CLAud**)

$\beta_0$  = constant (Y intercept)

$\beta_{1-3}$  = intercept (regression coefficients)

$x_1$  = level of good leadership (first predictor) (shortened as: **Led**)

$x_2$  = financial management (second predictor) (shortened as: **FinMgt**)

$x_3$  = Governance (third predictor) (shortened as: **Gov**)

e = error = 0

*The model can thus be rewritten as:  $\wedge\text{CLAud} = \beta_0 + \beta_1*\text{Led} + \beta_2*\text{FinMgt} + \beta_3*\text{Gov}$*

**Significance Test:** the regression analysis is tested at the 5% alpha level of acceptance; this means that a predictor variable (leadership, financial management and governance) is interpreted as significant if the *P* value is less than or equal to 0.05 in the regression results. Conversely, *P* values greater than 0.05 will not be regarded as significant.

### **8.3.1 Regression results and research questions 1, 2 and 3**

Since there are three independent variables (leadership, financial management and governance) that the Auditor General of South Africa (AGSA) regards as predictors of the achievement of 'clean audits', these variables were treated as the independent variables when analysing the data to answer the three major research questions. In each of the three research questions, clean audit (CLAud) is the dependent or predicted variable. Accordingly, the three research questions are tested jointly in the panel data multiple regression tests presented in Table 8.1 below, and the findings and discussion are presented by research question in section 8.4.



**Table 8.1a: Panel data regression result on determinants of clean audit**

Model 1: Fixed-effects, using 45 observations

Included 9 cross-sectional units

Time-series length = 5

Dependent variable: CLAud

	<i>Coefficient</i>	<i>Std. Error</i>	<i>t-ratio</i>	<i>p-value</i>	
Const	0.00625216	0.0391544	0.1597	0.87411	
Led	-0.305691	0.20921	-1.4612	0.15343	
FiNMgt	0.0759174	0.222275	0.3415	0.73486	
Gov	0.372729	0.167607	2.2238	0.03312	**

\*\* - statistically significant at 0.05 level of significance

Mean dependent var	0.052667		S.D. dependent var	0.076853
Sum squared resid	0.121424		S.E. of regression	0.060659
R-squared	0.532769		Adjusted R-squared	0.377026
F(11, 33)	3.420812		P-value(F)	0.002995
Log-likelihood	69.23819		Akaike criterion	-114.4764
Schwarz criterion	-92.79644		Hannan-Quinn	-106.3943
rho	0.118387		Durbin-Watson	1.360923

An heteroskedasticity test indicated the existence of heteroskedasticity in the result. As Fox (1997:306), indicates, "*unequal error variance is worth correcting only when the problem is severe*". Other experts advise that students should not worry too much about the presence of heteroskedasticity in their model results (Gujarati & Porter, 2009), and that a good result or model may not be rejected purely based on the presence of heteroskedasticity (Fox, 1997; Mankiw, 1990; Gujarati & Porter, 2009). However, the researcher chose to correct for the presence of heteroskedasticity to enhance the validity of the result, and a heteroskedasticity-correction test was therefore run. Table 8.1b presents the results after correcting for heteroskedasticity.

**Table 8.1b: Panel data regression result on determinants of clean audit**

Model 1: Heteroskedasticity-corrected, using 45 observations

Dependent variable: CLAud

	<i>Coefficient</i>	<i>Std. Error</i>	<i>t-ratio</i>	<i>p-value</i>	
const	-0.00396968	0.0054476	-0.7287	0.47033	
Led	-0.0871578	0.131639	-0.6621	0.51161	
FinMgt	0.183806	0.130593	1.4075	0.16682	
Gov	0.190475	0.0781683	2.4367	0.01925	**

\*\* - statistically significant at 0.05 level of significance

Statistics based on the weighted data:

Sum squared resid	140.9803	S.E. of regression	1.854331
R-squared	0.549620	Adjusted R-squared	0.516665
F(3, 41)	16.67807	P-value(F)	3.11e-07
Log-likelihood	-89.54628	Akaike criterion	187.0926
Schwarz criterion	194.3192	Hannan-Quinn	189.7866

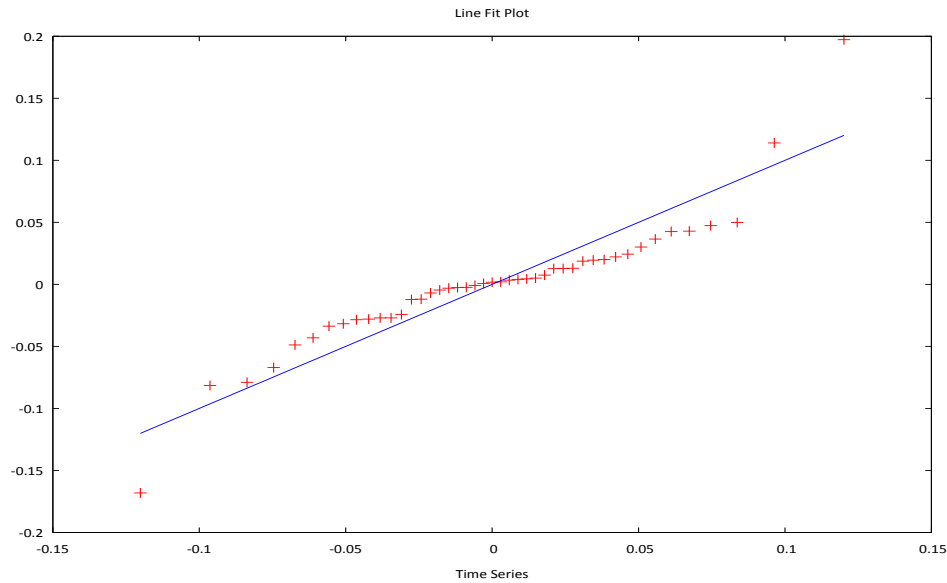
Statistics based on the original data:

Mean dependent var	0.052667	S.D. dependent var	0.076853
Sum squared resid	0.187311	S.E. of regression	0.067591

Model Result from panel data multiple regression:

$$\hat{CLAud} = -0.00397 - 0.0872 * Led + 0.184 * FinMgt + 0.190 * Gov$$

As shown in Table 8.1b, the F-statistic indicates that the independent variables (leadership [Led], financial management [FinMgt] and governance [Gov]) are jointly statistically significant at  $F=16.67807$  and  $P=0.000$  (0%), which means ( $F=16.67807$  and  $P=0.000 < 0.05$ ). This implies that the resultant significance level of 0% is less than the 0.05 ceiling, and therefore the joint relationship between leadership [Led], financial management [FinMgt] and governance [Gov], and clean audit [CLaud] is highly significant.



**Figure 8.3: Line fit plot of clean audit on the independent variables**

Furthermore, the regression result in Table 8.1b shows that the coefficient of determination ( $R^2$ ) of 0.549620 (55%); means that 55% of changes occurring in the dependent variable (clean audit) were accounted for by the predictive variables (leadership [Led], financial management [FinMgt] and governance [Gov]) in the panel data regression. This predictive power of the independent variables is also depicted in the closeness of the line plot's fit in Figure 8.3 and this results in the output model =  $\hat{CLAud} = -0.00397 - 0.0872 \cdot Led + 0.184 \cdot FiNMgt + 0.190 \cdot Gov$ . However, an adjusted  $R^2$  reduces the predictive power of the independent variables slightly to 0.516665 (52%) which is still significant. The joint significance result of  $P$  value of 0%, shows that the combined effect of leadership, financial management and governance is highly significant in their influence on the achievement of clean audits. However, the picture is not the same when looking at the results for the individual independent variables. These individual results will thus be discussed next, in section 8.4, to provide answers to the three main research questions.

#### **8.4 DISCUSSION OF FINDINGS EMERGING FROM THE STATISTICAL ANALYSIS OF THE RESEARCH QUESTIONS**

Sections 8.4.1 to 8.4.3 present discussions of the findings associated with the individual research questions, obtained from the panel data regression analysis

results in Tables 8.1a and 8.1b. Given the overriding predictive power of governance on clean audit outcomes (as shown in the regression result), the researcher conducted further regression analyses on the factors that enhance the predictive power of governance. These analyses are also presented in Section 8.4.3 to augment the understanding of the importance of governance in the achievement of a 'clean audit'.

#### **8.4.1 Discussion of findings emerging from the statistical analysis in support of research question 1**

*How does leadership affect the achievement of 'clean audit' outcomes?*

The regression result in Table 8.1a shows that the combination of leadership, financial management and governance significantly affects progress to the achievement of 'clean audit' at  $P=0\%$ , which is less than the stated research significance maximum level of 5%. However, examination of the individual independent variables contained in the individual research questions shows a different result.

An examination of the effectiveness of leadership as a driver of 'clean audit' outcomes, as seen from the regression result in Table 8.1b, shows that leadership's effect on the achievement of a clean audit is statistically insignificant at 0.51161 (or 51%), which is substantially higher than the maximum significance level of 5% set for this research. The result shows that, although leadership in combination with the other variables has contributed to their overall significance, leadership as a single variable has not been a very strong or statistically significant influence on efforts to achieve clean audits. This means that leadership, as a single variable, did not make a statistically significant contribution to the achievement of clean audit outcomes within the five year study period. This statistical finding may thus corroborate the AGSA's low ratings of leadership effectiveness in the annual audit reports of 2009/2010 - 2013/2014. And this finding is consistent with previous research findings which indicate that a low level of leadership commitment and weak monitoring processes pose challenge to the implementation of transparency and financial management accountability in the public sector (Gray & Manson, 2005; Madonsela,

2013; Holm & Zaman, 2012; Koelble & Siddle, 2014; Kerber, et al. 2015; Sancino & Castellani, 2016). However, this finding is contrary to some previous research which found that leadership does contribute effectively (and statistically significantly) to public sector strategies and accountability (Phillips, et al. 2014; Kats, et al. 2015). Whilst it is not disputed that leadership contributes to public sector financial accountability, it is however only *effective* leadership that is likely to enhance public financial accountability and the achievement of 'clean audits' (AGSA, 2013). Weak leadership derails public sector strategies, does not pursue objectives with sufficient vigour, and undermines financial management and accountability, and service delivery (Ngwakwe, 2012). Accordingly, the above findings have provided an answer to Research Question 1: leadership does have a relationship with the achievement of 'clean audits'. However, the relationship has two dimensions: firstly, leadership, when considered together with the other independent variables (financial management and governance) contributes to a jointly significant relationship that enhances the probability of achieving 'clean audits'. Secondly, when analysed as a single variable, leadership does have an effect on the achievement of 'clean audits', but the effect is somewhat weak: the regression coefficients show that a one percent (1%) rise in leadership effectiveness will cause only an 8% rise in the number of 'clean audits' achieved. Thus, while there should be a concerted effort to improve the effectiveness of leadership in order to speed up the realisation of the 'clean audit' goal in South Africa's public service, it is not the dominant driver of improvement.

#### **8.4.2 Discussion of findings emerging from the statistical analysis in support of research question 2**

*How does financial management affect the achievement of 'clean audit' outcomes?*

The regression result in Table 8.1a reveals that the combined effect of financial management, leadership and governance significantly affects progress to the achievement of 'clean audits'. Nonetheless, the analysis of the data with financial management as an individual, separate predictor variable (to address Research Question two (2)), reveals that the predictive ability of financial management on the achievement of 'clean audits' is different from the combined group result.

An analysis of the predictive effect of financial management on the achievement of 'clean audits', from the regression result in Table 8.1b, indicates that financial management's effect on efforts to achieve 'clean audits' is statistically insignificant at  $P=0.16682$  (or 16%), which is much greater than the significance level set at 5% for this research. Therefore, this finding reveals that, whilst financial management does have significance when in combination with the other two independent variables, on the achievement of 'clean audits', the predictive ability of financial management as a stand-alone variable is statistically insignificant as far as enhancing the achievement of 'clean audits' is concerned. This means that financial management as a stand-alone independent variable was a weak contributor to the achievement of 'clean audit' outcomes during the five years being studied. This statistical finding corroborates the low ratings of the effectiveness of financial management given by the AGSA in the annual audit reports of 2009/2010 - 2013/2014. However, this finding is different from previous research findings which indicate that effective financial management is pivotal to achieving public sector financial accountability, financial control and service delivery (Morrell & Kopanyi, 2014; Amujiri, 2013; IFAC & CIPFA, 2014).

The preceding findings answer Research Questions 2, in that they confirm that financial management has a relationship with efforts to achieve 'clean audits' in South Africa's public sector. However, this relationship also has two dimensions: firstly, financial management, when considered together with the other independent variables (leadership, and governance) does have a positive effect on efforts to achieve 'clean audits'. Secondly, as a single variable, financial management does still have an effect on the achievement of 'clean audits', but the effect is statistically weak.

#### **8.4.3 Discussion of findings emerging from the statistical analysis in support of research question 3**

*How does governance affect the achievement of 'clean audit' outcomes?*

Findings from Table 8.1 indicate that the combined predictive effect of the three independent variables (leadership, financial management and governance)

significantly affects progress to the achievement of 'clean audits'. Nevertheless, an analysis of the data using governance as a separate predictor variable (in response to Research Question three (3)), reveals a different assessment of governance's predictive ability regarding the achievement of 'clean audits'.

A close examination of the predictive ability of governance regarding the achievement of 'clean audits' using the panel data regression result in Table 8.1b indicates that, unlike the other variables, when analysed individually governance's effect on progress towards the achievement of 'clean audits' is statistically significant at 0.01925 (or less than 2%), which is well below the designated significance or alpha level of 5% set for this research. Thus, it is only the governance variable that has a P value of less than the alpha of 0.05 or  $P=0.01 < 0.05$ . Furthermore, the regression coefficients show that a one percent (1%) rise in the effectiveness of governance would cause a 19% rise in the number of 'clean audits' achieved, which is meaningfully higher than for the other independent variables, and thus a better 'return on investment' should the AGSA decide to invest training effort in this area.

The highly significant result of governance's impact on the achievement of 'clean audits' shows that, of the three independent variables, the governance variable is dominant in its ability to increase the number of 'clean audits', and thus deserves greater attention from the AGSA and other organs of state. Governance is an important vehicle for improving the number of 'clean audits' achieved in South Africa annually, both when evaluated in combination with the other independent variables, and when evaluated as a single variable. Only the governance variable as a stand-alone variable has a statistically significant predictive ability as far as enhancing the achievement of 'clean audits' is concerned.

The above findings and discussion about governance have therefore provided an answer to Research Questions 3: governance does have a positive relationship with progress to the achievement of 'clean audits' in South Africa. This relationship also has two dimensions: firstly, governance, when considered together with the other two independent variables (leadership, and financial management), contributes a strong influence to efforts to achieve 'clean audits'. Secondly, as a single, independent variable, governance still has a strong and statistically significant effect

on the achievement of 'clean audits', to a significantly greater extent than either leadership or financial management.

This research finding, confirming the strong influence of governance on audit outcomes, concurs with previous research conducted in other countries which, among other results, have identified that strong corporate governance results in good audit outcomes, as well as diminishing the negative impact of potentially unprofessional auditors (Pedro Sánchez Ballesta & Garcia-Meca, 2005). In addition, improvement in corporate governance leads to improved accountability, compliance with disclosure requirements and improved audit outcomes (Gao & Kling, 2012). There is therefore no doubt that governance aspects or variables such as internal audit, risk management and the audit committee, have played an immense role in boosting the strength of governance in the South African public sector, enabling it to influence audit outcomes positively. In view of the multi-dimensional nature of governance, it is deemed pertinent now to examine how these governance variables have individually contributed to the strength of governance in the South African public sector. Intriguingly, the literature search was essentially barren when the researcher looked for data on how governance variables or dimensions influence (either individually or severally) the overall strength of governance. Therefore, additional analysis of the municipal audit data was performed, with the intention of determining how governance variables influence the strength of governance. These results are discussed next.

### ***Relative Effectiveness of Individual Governance Variables on Governance***

Given the dominant influence of governance on South African municipalities' progress to the achievement of 'clean audits', the researcher undertook additional analysis of the data, specifically of the factors that influence the effectiveness of governance (internal audit, risk management and the audit committee), to determine which (if any) of these variables plays a dominant role in enhancing the effectiveness of governance. Table 8.2 presents a panel regression analysis using governance and the three independent variables that catalyse the effectiveness of governance – internal audit, risk management and the audit committee.



**Table 8.2: Panel data regression on the relative effectiveness of governance's component variables on governance**

Model 1: Fixed-effects, using 45 observations

Included 9 cross-sectional units

Time-series length = 5

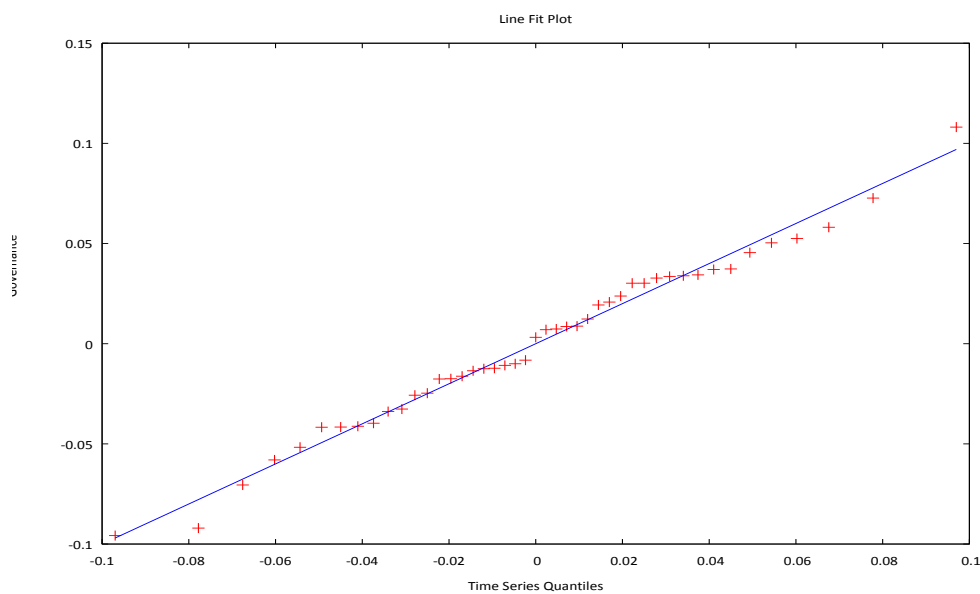
Dependent variable: Governance

	<i>Coefficient</i>	<i>Std. Error</i>	<i>t-ratio</i>	<i>p-value</i>	
Const	0.129933	0.0237597	5.4686	<0.00001	***
Int_Audit	0.106544	0.128505	0.8291	0.41300	
AuditCom	0.378701	0.116758	3.2435	0.00270	**
RiskMgt	0.0755811	0.105963	0.7133	0.48069	

\*\*\* - statistically significant at 0.001 level of significance

\*\* - statistically significant at 0.01 level of significance

Mean dependent var	0.276000		S.D. dependent var	0.242247
Sum squared resid	0.079150		S.E. of regression	0.048974
R-squared	0.969347		Adjusted R-squared	0.959129
F(11, 33)	94.86842		P-value(F)	1.06e-21
Log-likelihood	78.86704		Akaike criterion	-133.7341
Schwarz criterion	-112.0541		Hannan-Quinn	-125.6520
rho	0.328847		Durbin-Watson	1.138332



**Figure 8.4: Line fit plot of governance on governance factors**

Table 8.2 reveals a significant correlation to exist between the audit committee and governance. The panel regression results show that the combination of internal audit, audit committee and risk management exert a strong influence on governance, with a *P-value* of 1.06e-21, which is less than 1 percent. However, examination of the relative influences of the individual variables that comprise governance show that the audit committee variable, with a *P-value* of 0.00270 (less than 1 percent) has the strongest positive and thus most significant influence on governance.

This statistically significant relationship points to the underlying importance of the audit committee in that its contributions include the ability to enhance the accountability of governance in the public sector. In the local government structures the audit committee's role influences the entire council and its other committees. Its importance is vital as it coordinates all the activities of the various assurance providers. It does so by assessing the financial internal controls (which have a great impact on financial management and risk management), and also by determining and assessing the 'going concern' status of the of their municipalities. Both internal audit and risk management are important tools of governance (Mebratu, 2015), and the role of the audit committee is to oversee the integration of the reports from all assurance providers (RSA, 2003). In other words, the essence of the audit committee is to champion, coordinate and integrate the outputs of all its constituent committees (Mebratu, 2015).

This finding identifying the significantly positive effect of the audit committee on governance is supported by previous studies which have also identified the existence of a positive relationship between effective audit committees and governance structures (Mebratu, 2015; Oktorina & Wedari, 2015; Brennan & Kirwan, 2015). These results indicate that the audit committee is dominant in its ability to influence the effectiveness of the governance function in the public sector. But, despite this positive result and the support of prior research, this finding is contrary to the findings of other recent research which indicates that there is a lack of significance in the relationship between the audit committee's effectiveness and good governance (Al-Matari, et al. 2014).

## 8.5 SUMMARY OF THE CHAPTER

In this chapter the factors affecting progress towards the achievement of 'clean audit' opinions in South African local government entities has been analysed and interpreted using the panel-data consisting of the consolidated municipal audit reports from the nine provinces of South Africa. This data produced forty-five (45) time series observations and these were analysed using multiple regression statistics. The analysis was conducted to provide answers to the three main research questions, which are: how does leadership affect the achievement of 'clean audit' outcomes? how does financial management affect the achievement of 'clean audit' outcomes? and, how does governance affect the achievement of 'clean audit' outcomes?

On the one hand, the regression results showed that, when considered jointly, a significant relationship where  $P < 0.01$  exists between the independent variables (leadership, financial management and governance) and the achievement of 'clean audits'. On the other hand, an examination of the results from the multiple regression statistics on each of the individual independent variables showed insignificant regression coefficients for leadership and financial management. However, the regression result for governance showed a significant regression coefficient. Thus, the trio of leadership, financial management and governance collectively have a significant influence on the achievement of 'clean audits', but as individual variables, both leadership and financial management have a weak influence on the achievement of 'clean audits'. (This indicates a degree of inefficiency in the leadership and financial management functions of South Africa's local governments.) Nevertheless, when analysed as a single variable, governance has a strong and statistically significant influence on the achievement of 'clean audits', which thus also indicates the relative efficiency of municipal governance functions. The identification of this strong relationship between governance and the achievement of 'clean audit' outcomes prompted the researcher to further examine the effectiveness of the roles that the component variables of governance play, both jointly and individually, in enhancing the strength of governance. Using a similar panel data approach, the multiple regression statistics showed that collectively, the governance variables of internal audit, risk management and the audit committee, have a strong

influence on the effectiveness of governance ( $P < 0.001$ ). However, examination of the influences of the individual governance variables showed that the audit committee exhibits a dominantly significant influence on governance ( $P < 0.01$ ). This indicates that the work of the audit committees deserves closer scrutiny by the Auditor General of South Africa during the annual municipal audits, in an effort to strengthen the function further. Accordingly, the researcher suggests that, in addition to the performance of the normal audit, the AGSA's auditors should also audit the variables affecting the effectiveness of the audit committee in order to reinforce the effectiveness of the audit committee. This point is re-emphasized in Chapter 9 in the discussion of the suggested guidance framework.

## CHAPTER 9

### CONCLUSIONS AND RECOMMENDATIONS

#### 9.1 INTRODUCTION

This chapter presents a summary of the findings from the statistical analysis discussed in Chapter 8, and indicates how these findings have met the objectives of this research (including a contribution to the body of academic knowledge, as is expected of a doctoral research project (Isaac, et al. 1992; Thomas, 2015)). As will be discussed in the subsequent sections, this thesis has contributed to the body of knowledge in three specific areas: firstly, by answering research question 4 (objective 4) by proposing a framework for understanding the factors that affect the achievement of clean audits in the South African public service; secondly, by making use of the framework, further research recommendations (with a suggested model) have been provided as starting points for further research; and thirdly, the researcher has presented a proposal on how to improve public sector audits so as to enhance number of clean audits achieved. These are discussed sequentially in the following sections.

#### 9.2 SUMMARY OF FINDINGS

The findings are summarised according to the research objectives as follows:

***Objective 1: To examine the effect of leadership on the achievement of clean audit outcomes.***

The acceptable significance or alpha level for this research was set at 5%, hence a *P* value result within the range from 0 - 5% is regarded as significant, whilst any value above 5% is regarded as insignificant.

The first objective of this research was to examine the effect of leadership on the achievement of clean audits. This examination was conducted in two phases: the first phase examined the performance of leadership in conjunction with the other

independent variables, on the achievement of clean audits. The results show that leadership does contribute to the influence the three independent variables (leadership, financial management and governance) collectively have on the achievement of clean audits. However, when scrutinizing the effect of leadership as a single variable on the achievement of a clean audit, the regression coefficients show that a 1% increase in leadership quality contributes an 8% improvement in the cleanness of the audit. This shows that indeed, leadership can affect the cleanness of the audit, but this relationship is at an extreme *P* value of 51%, which is markedly higher than the acceptable maximum alpha value of 5% set for this research (see Table 8.3b). Accordingly, although leadership does contribute positively to the combined significance of all the variables, the influence of leadership, as a single variable, was not statistically significant in enhancing the achievement of clean audits. This result (that leadership as a single variable has not had made a statistically significant contribution to the achievement of clean audits) is consistent over the five years of data studied (2009/2010 - 2013/2014). This result concurs with the findings of Krohmer and Noël (2010) on the relationship between leadership and audit quality. However, this absence of a significant relationship is contrary to the results of more recent studies on audit quality and leadership (Webb, 2015; Francis, 2004; Jelic, 2012). These studies were conducted on private sector organisations.

It is therefore useful to note that the insignificant correlation between leadership quality and the achievement of a clean audit may be explained by the fact that leadership in the South African local government arena is made up of politically appointed officials, municipal councils and administrators (Giroux & McLelland, 2003; PWC, 2010; Zhang, 2014; IFAC, 2013). These leaders should be regarded as responsible for promoting (both directly and indirectly) the improvement of audit quality: hence, by this insignificant correlation they can be seen to be failing to execute their primary responsibilities. However, a previous study by Tarasovich and Lyons (2015) on the use of the so-called leadership toolbox, reported that leadership does require some competencies in the financial arena in order to assist the organisation to achieve its intended objective. Another probable reason for the insignificance of the influence of leadership on the achievement of clean audits is that the municipal leaders have challenges in the areas of public accountability, financial accountability, and generally display a lack of administrative competencies

(AGSA, 2011/12). There is also a demonstrable lack of ethical leadership (Ricketts & Ricketts, 2011; Disoloane, 2012; Madonsela, 2013), which makes local governments vulnerable to irregular acts, maladministration and corruption throughout their systems. Thus, by implication, through improving the technical competencies of leadership a culture of effective and efficient service delivery could be achieved, and local economic growth targets met.

This analysis and associated findings on the relationship between leadership and the achievement of clean audits, achieves objective one of this research.

***Objective 2: To examine the effect of financial management on the achievement of clean audit outcomes.***

The second objective of this research was to examine the effect of financial management on the achievement of clean audit outcomes. This examination was done on two levels. The first level examined the importance of financial management, in conjunction with the other independent variables (leadership and governance), on the achievement of clean audits. Analysis of the data in Table 8.3b in Chapter 8, shows that financial management (as one of the three key variables which the AGSA regards as key drivers for improving audit outcomes) does play an important part in improving audit outcomes. In combination, the three independent variables have a highly significant  $P$  value of 0%, which is significantly lower than the alpha of 5% set for this research. However, an examination of the effect of financial management (as a stand-alone variable) on clean audit, shows that financial management has been only weakly associated with the achievement of clean audits in the municipalities of South Africa during the five years studied. As a single (stand-alone) variable, financial management produced  $P$  value of 16%, which is higher than the maximum alpha value of 5% deemed appropriate for this research. This result shows that financial management (both as a single variable and in combination with the other two variables), has an effect on the achievement of clean audits in the country, but its stand-alone impact on the achievement of clean audits is statistically weak. Despite this weakness, though, the regression coefficient shows that a 1% improvement in the quality of financial management would result to an 18% improvement in the level of clean audits achieved (see Chapter 8 Table 8.3b).

These results concur with the findings of Kaklar, et al. (2012) who found there to be a weak relationship between financial management and audit quality. However, Ziaee (2014), who also investigated the relationship between financial management and audit quality, finds a strong positive relationship to exist between the two. According to Herath (2015), a weak relationship between financial management and public sector audit outcomes may indicate weak or inefficient that financial management in the public sector is either weak or inefficient. This weakness and/or inefficiency appears probable in the context of this research, as the occurrence of poor budget planning and poor budget preparation, together with the absence of integrated financial management systems and performance measurement have previously been identified by the World Bank (1998). The weak relationship between financial management and clean audit outcomes can therefore be attributed to a general lack of competencies in the public service, and to specific shortages of appropriately qualified personnel in the accounting sections of these entities (AGSA, 2011/12). This state of affairs would suggest that local governments should endeavour to employ people with appropriate technical competencies and experience in financial management.

This analysis and associated findings on the relationship between financial management and the achievement of clean audits, achieves objective two of this research.

***Objective 3: To examine the effect of governance on the achievement of clean audit outcomes.***

In order to achieve objective 3 of this research, the effect of governance on the achievement of clean audits was examined at two levels: first governance was investigated in conjunction with the other two variables (leadership and financial management), and secondly, as a stand-alone variable. The results presented in Table 8.3b of Chapter 8, and subsequent analysis, shows that governance contributes to the significance of the three variables where they collectively present a *P* value of 0%, indicating the existence of a highly significant relationship between the three variable and the achievement of a clean audit. The effect of governance as a stand-alone variable on the achievement of a clean audit outcome was also



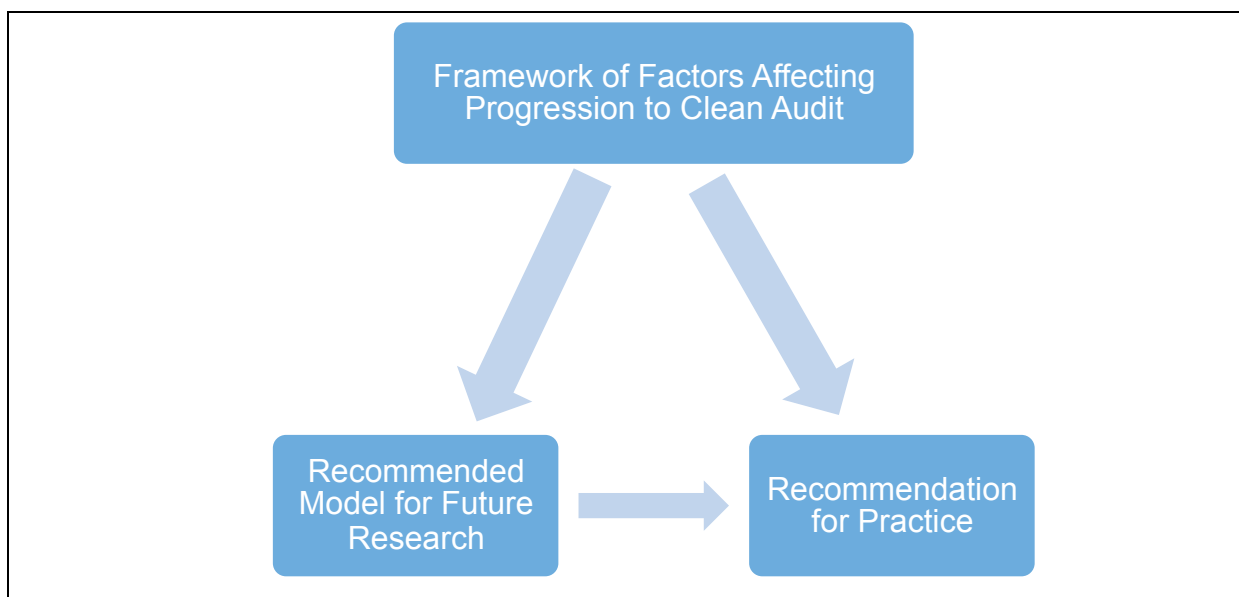
examined, and the results presented in Table 8.3b indicate that the effect of governance is significant: the  $P$  value of 0.019 is substantially less than the 5% maximum level of alpha that was used in this research. These findings are consistent with prior research, which has documented the existence of a strong positive relationship between governance and audit quality (Gajevszky, 2014; Fooladi & Farhadi, 2011; Alrshah, 2015).

Given the strong influence of governance on the achievement of clean audits in South African municipalities, as shown in the analysis of the data underlying this research, the researcher decided to analyse the factors that enhance the effectiveness of governance. The literature review identified internal audit, risk management and the audit committee as the important variables that affect the efficiency of governance. Hence these three variables were regressed on governance to examine each of their relative effects on governance. The results, presented in Table 8.4, showed that these variables collectively have a statistically highly significant effect on governance effectiveness. However, an examination of each of the individual variables indicated that it was the audit committee that has the dominant influence on governance effectiveness. These findings provided the researcher with additional variables to include in the proposed framework (Objective 4) for understanding the factors that affect the achievement of clean audits in South African municipalities. Thus, the findings presented in Table 8.3b of Chapter 8 show that objective 3 of this study has been achieved and that governance has a significant effect on the achievement of a clean audit.

**Objective 4:** The fourth research objective was to propose a framework to assist in understanding the factors that affect progress to a clean audit, and thus to contribute to the extension of knowledge on the subject. Given, therefore, that research objective four's primary aim is to contribute knowledge and literature on the state of public sector audit in South Africa, the proposed framework (objective 4) is presented in greater detail next.

### 9.2.1 Thesis' contribution to knowledge

A doctoral thesis is expected to contribute a new idea or a new perspective on existing knowledge, and to the body of academic literature and/or professional practice (Gill & Dolan, 2015; Baillie, 2015). This research extends the existing body of knowledge by presenting a framework intended to enhance the understanding of the factors that affect progress to a clean audit. The thesis' contribution to knowledge addresses two distinct dimensions. The first dimension comprises a framework for understanding the factors that affect an organisation's progress to achieving a clean audit in the South African municipal management arena. The second dimension emerges from the framework in the form of two unique recommendations – for further research and for improving audit practice in the public sector. The first recommendation is an agenda for further research through implementing the proposed model that evaluates the factors that affect audit committee effectiveness in South African municipalities. The second recommendation is that additional variables (not considered in AGSA's current practice, but identified during this research) be included in the AGSA's annual audit of the effectiveness of municipal audit committees. The research contribution is presented graphically below in Figure 9.1:



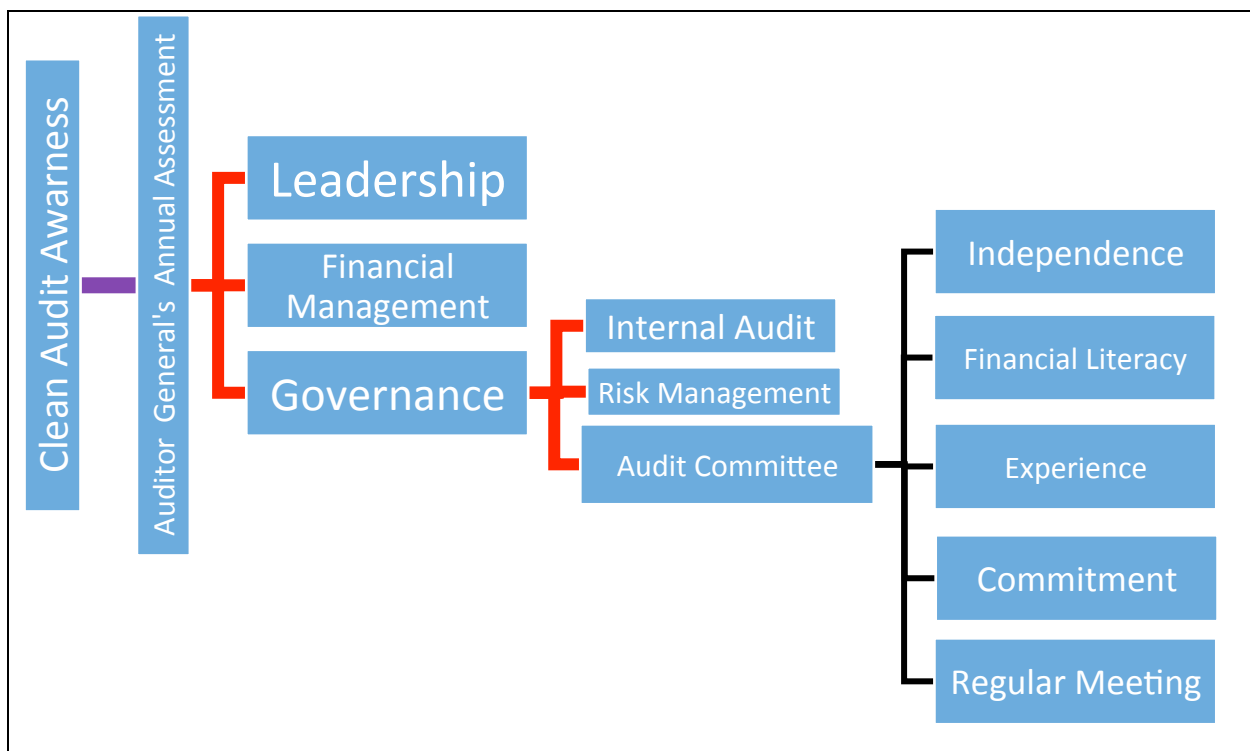
**Figure 9.1: Graphical representation of research contribution to knowledge**

### **9.2.2 Suggested framework for understanding the factors affecting progression to achieving a clean audit**

Every journey begins with a dream, and for the South African public sector the dream was (and is) for the achievement of clean audits. 'Clean audit' formally entered the auditing lexicon in the Republic of South Africa in 2009, and is the pivotal concept of this framework (Figure 9.2). Key to the progression to the achievement of clean audits in the South African public sector is the emergence of a general awareness of the concept (COGTA, 2009). The term 'clean audit' has generally replaced the more cumbersome and conventional term 'unqualified audit opinion', which was previously the best audit outcome to achieve. However, the essential change that the introduction of the term 'clean' introduced was this: whereas the previously preferred 'unqualified audit opinion' could still contain an auditor's clause identifying 'some material errors', the 'clean audit' variation is not expected to contain any clause identifying a material error. Thus, an unqualified audit opinion that contains no clause identifying any material error is now referred to as a 'clean audit opinion' by the Auditor General of South Africa (AGSA); and in 2009 the AGSA began the journey that was supposed to end in 2014 with the universal achievement of clean audits throughout the South African public sector. However, this noble ambition has continued to prove elusive (Powell, et al. 2014 ). The now necessary next phase of the journey to achieving clean audits required the pragmatic and systematic enforcement of compliance with the principles guiding the preparation of financial statements, with the country's laws and regulations, and the scrutiny of the efforts to achieve nationally predetermined development objectives by the Auditor General during its audits of municipalities. Thus, the auditor general's annual audits fill the second node on the framework (Figure 9.2) proposed for understanding factors affecting progress to the achievement of clean audits. Since the Auditor General believes that there are three variables that drive the clean audit effort (leadership, financial management and governance), these drivers form the third node in the proposed framework. Because the AGSA places so much reliance on these drivers to get the public service to clean audit status, it became irresistible to examine their real-world effectiveness, and to offer recommendation based on the outcome of this research. Recently published literature (Missioura, 2015; McKinney, 2015; Cao, et al. 2015; Lisic, et al. 2015) supports the Auditor General's focus on the

effectiveness of leadership, financial management and governance to improve audit outcomes. Similarly, the statistical analysis from this research presented in Chapter 8 supports the Auditor General's choice of drivers. However, the analysis also reveals new information not previously reported in the literature about these and other factors affecting audit outcomes. The first discovery was that leadership, financial management and governance, when assessed as a single entity, have a strongly significant relationship with clean audit outcomes. The second, and equally important discovery was that, when examined individually, only the governance variable showed a significant relationship with the achievement of clean audits; leadership and financial management, examined as individual variables, displayed only weak relationships with clean audit outcomes. Arising from these results, and especially given the significant effect of governance on the achievement of clean audits, it became obvious that further scrutiny of the governance variables was needed in order to determine the relative effectiveness of governance' sub-variables on the overall significance of governance in driving the process. This research resulted, therefore, in the inclusion of a three major node on the framework in Figure 9.1, which is rooted on governance. An examination of the relative effectiveness of the factors affecting governance, discussed in Chapter 8, revealed that internal audit, risk management and the presence of an audit committee jointly have a significant relationship with governance; however, an important result from the statistical analysis shows that only internal audit has a significant relationship with governance – the strength of its positive correlation far exceeds that of the other two aspects. This indicates that it is the audit committee that provides the major driving force within the governance cluster of disciplines that propels municipalities towards clean audit outcomes. The effectiveness of the audit committee thus necessitates the inclusion of the fifth (5<sup>th</sup>) major node on the framework illustrated as Figure 9.2. This fifth node contains the factors identified in the literature as having an effect on the efficiency of the audit committee. The factors that an audit committee is required to demonstrate (see Figure 9.2) are independence, financial literacy, experience, commitment and regular meeting. Published researchers including Cohen, et al. (2002), Morgan (2010), and Soliman and Ragab (2014) agree that it is the efficiency of application of these audit committee factors that enhances the efficiency of audit committee. In response to this, it appeared appropriate to extend the Auditor General's three-drivers-of-audit-outcomes framework to include these governance

variables and, in addition, the audit committee variables. This extension thus adds new knowledge to practice and opportunities for research. In audit practice the extended framework now suggests that audit scrutiny be extended to factors that affect audit committee effectiveness. In regard to research, these additional factors provide an agenda for further research to examine the relative effects of the audit committee factors on the audit committee's overall effectiveness. This proposed framework has not yet been published in any public sector auditing publication in South Africa, and hence the contribution of this research to auditing practice and ongoing academic research has still to be recognised. Subsequent sections contain recommendations on improvements to public sector audit practice, and identify future research directions arising from these finding. The assessment framework for factors affecting public sector entities' progress to the achievement of clean audits appears below as Figure 9.2.



**Figure 9.2: Proposed framework of factors affecting progression to clean audit (Source: Author's framework of factors affecting progression to clean audit)**

### **9.3 RECOMMENDED USE OF FRAMEWORK OF FACTORS IN FUTURE RESEARCH AND AUDIT PRACTICE**

In addition to the contribution to academic discourse offered by the proposed framework for understanding the factors affecting progress to clean audits, this research also contributes a proposed agenda for future research into the practices that are linked to the proposed framework (particularly those associated with the audit committee – see Figure 9.2). Thus, in addition to the contribution made through developing the proposed framework, this research has two additional recommendations/contributions – to ongoing research and to public sector audit practice. These contributions/recommendations are presented in the following sections.

#### **9.3.1 Recommendation for future research**

Drawing on the literature review findings and the analysis of the research data, the researcher has identified a need for further research on the factors affecting the effectiveness of municipal audit committees. As this research has shown, audit committees' contribution to the effectiveness of governance, and governance's impact on audit outcomes are significant. It therefore appears appropriate to strengthen the audit committee through an improved understanding of the factors that play a role in making the audit committee effective.

The literature review identified a number of factors that affect the effectiveness of audit committees (and are therefore reflected in the framework). These include independence, financial literacy, experience, commitment and regular meeting (Cohen, et al. 2002; Morgan, 2010; Soliman & Ragab, 2014). In addition, as the analysis of data in this research has shown that governance has a statistically significant influence on the achievement of clean audits, it thus suggests that the current pace at which clean audits are being achieved in South Africa can be accelerated if the government were to embark on initiatives to strengthen governance in municipalities. The strength of the governance aspect of municipal management was found to depend on the effectiveness of the audit committee, as the analysis of the data in this study showed. Making use of the variables that

influence audit committee effectiveness as identified in the literature review (and included in the framework – Figure 9.2), it appears that efforts should focus on enhancing the performance of those tasks/disciplines that contribute most to the creation of an effective audit committee. These arguably pivotal variables thus need to be brought to the attention of the AGSA’s audit administrators for inclusion in their efforts to upskill municipal administrations. Further research is thus needed to quantify the influence of these variables on audit committee effectiveness in South African municipalities. Identifying and ranking the significant variables, and enhancing the effectiveness of their performance may have the positive effect required to accelerate progress toward the ‘clean audit’ goal in South African public sector entities. Expressing this proposal in mathematical notation, the researcher’s suggested model for further research appears as follows:

$$\gamma = \beta_0 + \beta_1\chi_1 + \beta_2\chi_2 + \beta_3\chi_3 + \beta_4\chi_4 + \beta_5\chi_5 + \varepsilon \dots\dots\dots(1)$$

Where:

$\gamma$  = audit committee effectiveness

$\beta_0$  =  $\gamma$  intercept

$\beta_1 - \beta_5$  = regression coefficient

$\chi_1 - \chi_5$  = independence, financial literacy, experience, commitment and regular meeting

$\varepsilon$  = error

The recommended model for future research is operationalized as follows:

$$ACE = \beta_0 + \beta_1\chi_1 + \beta_2(ID) + \beta_3(FL) + \beta_4(EX) + \beta_5(CR) + \varepsilon \dots\dots\dots(2)$$

Where:

ACE = audit committee effectiveness

ID = independence,

FL = financial literacy,

EX = experience,

CR = commitment and regular meeting

### 9.3.2 Recommendation for practice

Given the apparently strong contributory role of audit committees to governance effectiveness, the implication of this research on current AGSA practice is that the AGSA should devote additional effort to the scrutiny of the workings of the audit committee. This would also require that more audit committee variables be identified and evaluated to ascertain those that have the greatest ability to enhance the effectiveness of audit committees.

Current criteria used by the AGSA in its assessment of audit committees' effectiveness appear to have excluded the important variables identified in this research and included in the suggested model for further research and implementation. The AGSA's existing guidance for assessing audit committees' effectiveness is:

*Ensure that the audit committee promotes accountability and service delivery through evaluating and monitoring responses to risks and providing oversight of the effectiveness of the internal control environment, including financial and performance reporting and compliance with laws and regulations (AGSA, 2013:16).*

The above somewhat nebulous statement appears to be in need of revision in light of this research which suggests additional, specific criteria against which to evaluate the effectiveness of audit committees. It appears appropriate that the AGSA should evaluate audit committee performances, and to determine whether they are conversant with and demonstrating the qualities now included in the suggested model. This appears particularly pertinent as the model now also reflects the latest published research findings (Cohen, et al. 2002; Morgan, 2010; Soliman & Ragab, 2014) in which these aspects have been identified as qualities necessary for an audit committee to function effectively.



### **9.3.3 Contribution to Public Administration**

This research contributes to the discipline of public administration, both in its practice and its academic study. The contribution is anchored on the vital role that national audit plays in stimulating efficient, accountable, effective and transparent public administration through which it is then possible to achieve national social and economic development goals which ensure the availability of social goods to the citizens, and curtails the grossest excesses of inequality. In addition, there is positive recognition that is fostered by professionalism in a country's supreme audit institution, such as the AGSA, amongst the international investing community, when a government's accountability is endorsed for its efficient and effective use of resources in achieving development goals (United Nations, 2016; INTOSAI, 2016).

In practice, two national institutions play critical oversight roles through the reviewing and monitoring of the effectiveness and efficiency of public administration and governance. These are the institution that is entrusted with the audit of national, provincial and municipal entities (the AGSA in South Africa's case), and the legislature. The results of the review and monitoring efforts are in the form of annual audit reports, and are the instruments that gauge the performance of public institutions and their custodians or the administrators. The audit reports (whether negative or positive) provide strategic direction to future public service delivery planning and controlling efforts in that they provide a kind of SWOT analysis of the entities' performances. However, for audit outcomes to provide a trusted strategic direction they must clearly identify the key function/s that are able to manage and motivate improvements in the performance of entities entrusted with service delivery. With respect, there is currently no section in the Auditor General's Annual Report structure that pinpoints the key functions that are (or should be) guiding public service administrations to achieve their highest standards. The current structure of the AGSA's report instead provides feedback on the performance of a grouping of three functions or variables that have been deemed to be the key drivers of service delivery against agreed targets (leadership, financial management and governance); these have been examined in this research.

In order to plan and execute effective public administration (at both the administrative and project-selection levels), effective monitoring and auditing policies are essential, as it is through these functions that the legislature is made aware of the manner in which these key function are driving public service accountability. This research has revealed that of the three key public administrative service functions identified by the AGSA, governance is significantly more efficient and effective at achieving the desired improvements than the other two. Within the governance function it is internal audit, the audit committee and the risk management function that have greatest potential to overcome the challenges facing the public sector.

#### **9.4 LIMITATIONS OF THE STUDY**

Every research endeavour has specific limitations and these should be considered by future researchers (Grosso, et al. 2015; Uher & Visalberghi, 2016). This research has limitations that arise particularly from the time period covered in the data analysis, and from the available variables and data quality. The time period was purposively selected to cover the official “journey to clean audit” timeframe, which commenced in 2009 and was intended to end in 2014 with the achievement of clean audits by all local governments. Thus the timeframe used in this research was only five years (2009/2010 - 2013/2014), and the results and their interpretation is limited to that period. The performance of leadership, financial management and governance prior to 2009 and after 2014 was not included in the analysis. As human nature and varying political ideas and forces provide unanalysed context for this research, these results are not automatically applicable to all spheres of government. The effectiveness of leadership, financial management and governance may improve in future financial time periods, and be different in other public sector entities, and future research might consider extending this work to determine the rate and extent of progress.

Another limitation is that the independent variables considered in the research were limited to those identified by the AGSA when launching its drive to improve audit outcomes (AGSA, 2013); other potential variables were not considered. Whilst the journey to clean audit was intended to achieve universal clean audits in municipal *and* provincial departments by 2014, the data used in this research was limited only

to that contained in the Auditor General's consolidated municipal audit reports from the nine provinces of the Republic: the audit reports for provincial departments were not used. Future researchers might therefore consider examining the provincial departments' reports, either separately or in combination with the municipal and national department reports. Despite these limitations though, this research has yielded new insights, usefully extending the current knowledge base, as has been recorded in the preceding sections.

## **9.5 CONCLUSION**

This research set out to examine the factors that influence specifically municipalities in their progress to a 'clean audit' outcome. The importance of this research lies in the vital role that effective public financial management plays in meeting service delivery objectives. Dwindling availability of public finance and the surge in maladministration in many emerging and developing nations has attracted the interest of researchers on public sector financial accountability from around the world (Schmidt & Günther, 2016; Arnaboldi, et al. 2015). However, ensuring effective accountability over public finance requires the presence of efficient internal controls which in turn have the potential to catalyse improved audit outcomes (Aziz, et al. 2015). The arrival of the new democratic period in South Africa has unfortunately been accompanied by a gradual weakening of public financial accountability, which has largely been attributed to a national shortage of appropriate financial skills (Soltani & Maupetit, 2015). Government's efforts to address the skills shortage continue to be reviewed, revised, researched and reported on in other academic disciplines, and did not therefore form part of this research study. However, in the National Government's efforts to improve efficient management of public finance and to channel the limited resources to the desired service delivery projects, a journey to improve public sector audit outcomes appears as good a place to start as any. Accordingly, in 2009 the South African Departments of Cooperative Governance and of Traditional Affairs (COGTA) initiated a campaign to achieve a new, improved level of audit outcome that they termed 'operation clean audit', with the intention of achieving clean municipal and provincial audits by 2014. The key to achieving this objective was the improvement of public financial management in all municipalities in all nine provinces by 2014 (Powell, et al. 2014). The Auditor General of South Africa

(AGSA) accepted the onerous responsibility to realise the 'operation clean audit' dream by adding a fifth level of opinion (clean audit opinion) to the annual municipal audit outcome options. In support of this dream, the AGSA identified three key factors that were assumed to drive the improvement of audit outcomes: these were leadership, financial management, and governance (AGSA, 2014). Audit results showed that this dream remained elusive and the 2014 deadline was not met. The researcher was intrigued, and discovered that no formal or published research had examined the relative effectiveness of the causative variables identified by the AGSA as essential to improving audit outcomes. Therefore, to begin to fill this research gap, and to make a contribution to knowledge (theory) and administrative and audit practice, this research was undertaken to examine the individual and collective effectiveness of leadership, financial management and governance in the achievement of a clean audit outcome. The methodology embraced a positivist paradigm as the research involved measuring (quantifying) the relationship between variables. Therefore the use of quantitative analysis appeared appropriate, and the panel data multiple regression approach was used to analyse the available data. The AGSA's consolidated municipal annual audit outcomes for the nine (9) provinces of South Africa for the five year period 2009/2010 - 2013/2014 provided the source data. Applying the panel data approach, the consolidated municipal annual audit outcome for the nine provinces over five years produced 45 panel observations, sufficient for effective regression analysis to be performed. Results from the regression analysis revealed important relationships in two dimensions. On the one hand, the three independent variables – leadership, financial management and governance – as a unit, demonstrated a significant relationship with clean audit outcomes, with a  $P < 0.01$  which is substantially lower than the 5% significance level set for this research. On the other hand, the independent variables were also analysed for their individual effects on clean audit outcomes. Results showed that only governance had a significant effect on the achievement of a clean audit. Given the dominance of the effect of governance on the clean audit outcome over the other variables, further analysis was conducted to determine the variables that influence the efficiency of governance. The results of this further research revealed the audit committee to be the overriding influence on the achievement of clean (improved) audit outcomes. The findings of this research confirm previously published results from other countries, which have all highlighted the presence of a relationship

between leadership, financial management and governance (Krohmer & Noël, 2010; Kaklar, et al. 2013; Gajevszky, 2014; Fooladi & Farhadi, 2011; Alrshah, 2015). The findings also corroborate previous research from other countries that highlight the positive effect of the audit committee on governance (Mebratu, 2015; Oktorina & Wedari, 2015; Brennan & Kirwan, 2015).

Based on the findings from the latest analysis, and with reference to current literature, satisfactory answers were provided to the three key research questions. Similarly, the three objectives of this research have been met as follows: findings from the data analysis confirm that leadership, in conjunction with financial management and governance functions, enjoys to a significant relationship with clean audit. However, leadership as a stand-alone variable has a weak effect on the achievement of clean audits. Similarly, financial management, in conjunction with leadership and governance, shows a significant relationship between the independent variables and the achievement of clean audits. However, as a stand-alone variable, financial management has a weak effect on the achievement of a clean audit. Finally, governance, in conjunction with financial management and leadership, also shows the existence of a significant relationship between the independent variables and the achievement of clean audits. But, as a stand-alone variable, governance proves to be the only variable with a statistically significant effect on the achievement of a clean audit. These results re-emphasize the seriousness of the weakness of leadership and financial management in the public sector and draw added attention to the need to improve the effectiveness of leadership and financial management, whilst making resources available to reinforce the current efficiency of governance will support the momentum already attained.

The fourth objective of this research was also achieved as the research provided sufficient information to enable the researcher to propose a framework for understanding the factors that affect the municipalities' progress to achieving clean audits. As no similar framework has yet been published, this thesis thus makes a new contribution to the body of knowledge on factors driving public sector audit improvements.

This research contribution has three dimensions to it: a proposed analytical framework; recommendations and guidelines for further research (by providing a model to research the variables that affect audit committee effectiveness), and a recommendation on how to improve public sector auditing by including the additional variables (identified when developing the analytical framework) in the scope of public sector audits. Therefore, this thesis has also contributed to the discipline of public administration in the following ways: the results of the statistical analysis have provided a new insight into the relative effectiveness of leadership, financial management and governance in the outcomes of public sector audits. This may then spur academic discussion and debates on the relative strengths of and interactions between these three variables on public sector auditing outcomes, and it is intended to use this research as a case study in the postgraduate class the researcher teaches. Similarly, the identification of the factors that enhance the effectiveness of governance contributes useful fuel to academic discussions and/or evidence pertinent in the teaching of public sector governance, and on its relation to audit outcomes. The finding that the audit committee is pivotal to the achievement of effective governance should motivate changes in the appointment of members to and monitoring policies of audit committees: political appointments should be avoided, with preference being given to the demonstration of appropriate skills and experience. In addition, the finding that it was the audit committee that was dominant in the achievement of good governance provided the impetus for this research to recommend a model for future research into the factors that enhance the effectiveness of public sector audit committee. This model does not yet exist in the literature and has not been researched, at least within a South African context. Finally, this research has contributed to public sector audit practice in that it has recommended an expansion of current audit procedures to include the scrutiny of the factors that affect audit committee effectiveness (see Figure 9.2 – the suggested framework). This is important, as these research results have conclusively demonstrated that the effectiveness of the audit committee strengthens governance, which in turn improves public sector audit outcomes.

Given that every research has some specific limitations (Grosso, et al. 2015; Uher & Visalberghi, 2016), it is appropriate to identify those pertaining to this research: these include the limited time period covered, and that the data and variables were those

of municipal entities in South Africa only. While the results of this research must be interpreted within the confines of its limitations, these limitations are worth considering as gaps in our collective knowledge and as opportunities for future researchers.

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## APPENDIXES

### APPENDIX 1

#### Data on leadership, financial management and governance

##### AGSA GENERAL AUDIT OUTCOMES FOR LOCAL GOVERNMENTS

##### EASTERN CAPE

Year of reporting	Leadership	Financial Management	Governance	Clean audit
	<b>X1</b>	<b>X2</b>	<b>X3</b>	<b>Y</b>
2009/10	6%	6%	6%	2%
2010/11	15%	14%	16%	2%
2011/12	11%	8%	15%	0%
2012/13	9%	7%	7%	0%
2013/14	10%	11%	9%	4%

##### FREE STATE

Year of reporting	Leadership	Financial Management	Governance	Clean audit
	<b>X1</b>	<b>X2</b>	<b>X3</b>	<b>Y</b>
2009/10	11%	5%	7%	0%
2010/11	13%	9%	8%	3%
2011/12	12%	8%	15%	3%
2012/13	9%	4%	6%	0%
2013/14	4%	0%	11%	0%



### GAUTENG

Year of reporting	Leadership	Financial Management	Governance	Clean audit
	<b>X1</b>	<b>X2</b>	<b>X3</b>	<b>Y</b>
2009/10	63%	51%	65%	15%
2010/11	45%	44%	61%	5%
2011/12	35%	33%	44%	6%
2012/13	49%	37%	59%	9%
2013/14	48%	43%	74%	39%

### KWAZULU-NATAL

Year of reporting	Leadership	Financial Management	Governance	Clean audit
	<b>X1</b>	<b>X2</b>	<b>X3</b>	<b>Y</b>
2009/10	55%	45%	55%	0%
2010/11	56%	44%	65%	7%
2011/12	44%	31%	53%	8%
2012/13	19%	21%	46%	15%
2013/14	35%	29%	71%	28%

### LIMPOPO

Year of reporting	Leadership	Financial Management	Governance	Clean audit
	<b>X1</b>	<b>X2</b>	<b>X3</b>	<b>Y</b>
2009/10	22%	20%	12%	3%
2010/11	8%	8%	6%	7%
2011/12	3%	7%	3%	3%
2012/13	8%	4%	8%	0%
2013/14	13%	6%	16%	0%

### MPUMALANGA

Year of reporting	Leadership	Financial Management	Governance	Clean audit
	<b>X1</b>	<b>X2</b>	<b>X3</b>	<b>Y</b>
2009/10	35%	21%	43%	14%
2010/11	35%	30%	30%	19%
2011/12	26%	21%	26%	9%
2012/13	14%	10%	19%	10%
2013/14	11%	11%	22%	10%

### NORTHERN CAPE

Year of reporting	Leadership	Financial Management	Governance	Clean audit
	<b>X1</b>	<b>X2</b>	<b>X3</b>	<b>Y</b>
2009/10	11%	9%	9%	5%
2010/11	0%	0%	5%	0%
2011/12	9%	9%	9%	0%
2012/13	11%	7%	18%	3%
2013/14	10%	12%	23%	6%

### NORTH WEST

Year of reporting	Leadership	Financial Management	Governance	Clean audit
	<b>X1</b>	<b>X2</b>	<b>X3</b>	<b>Y</b>
2009/10	3%	8%	3%	0%
2010/11	3%	2%	1%	0%
2011/12	4%	4%	4%	0%
2012/13	2%	2%	1%	0%
2013/14	5%	6%	2%	0%

**WESTERN CAPE**

<b>Year of reporting</b>	<b>Leadership</b>	<b>Financial Management</b>	<b>Governance</b>	<b>Clean audit</b>
	<b>X1</b>	<b>X2</b>	<b>X3</b>	<b>Y</b>
2009/10	46%	47%	55%	9%
2010/11	48%	33%	47%	7%
2011/12	53%	35%	53%	17%
2012/13	52%	38%	63%	38%
2013/14	60%	43%	71%	55%

## APPENDIX 2

### Geographical analysis of current state of clean audit in South Africa

CLEAN AUDIT PROGRESSION	
Eastern Cape	
Year of reporting	Clean Audit
2009/2010	2%
2010/2011	2%
2011/2012	0%
2012/2013	0%
2013/2014	4%

Free State	
Year of reporting	Clean Audit
2009/2010	0%
2010/2011	3%
2011/2012	3%
2012/2013	0%
2013/2014	0%

Gauteng	
Year of reporting	Clean Audit
2009/2010	15%
2010/2011	5%
2011/2012	6%
2012/2013	9%
2013/2014	39%

<b>Kwa-Zulu Natal</b>	
<b>Year of reporting</b>	<b>Clean Audit</b>
2009/2010	0%
2010/2011	7%
2011/2012	8%
2012/2013	15%
2013/2014	28%

<b>Limpopo</b>	
<b>Year of reporting</b>	<b>Clean Audit</b>
2009/2010	3%
2010/2011	7%
2011/2012	3%
2012/2013	0%
2013/2014	0%

<b>Mpumalanga</b>	
<b>Year of reporting</b>	<b>Clean Audit</b>
2009/2010	14%
2010/2011	19%
2011/2012	9%
2012/2013	10%
2013/2014	10%

<b>North West</b>	
<b>Year of reporting</b>	<b>Clean Audit</b>
2009/2010	0%
2010/2011	0%
2011/2012	0%
2012/2013	0%
2013/2014	0%

<b>Northern Cape</b>	
<b>Year of reporting</b>	<b>Clean Audit</b>
2009/2010	5%
2010/2011	0%
2011/2012	0%
2012/2013	3%
2013/2014	6%

<b>Western Cape</b>	
<b>Year of reporting</b>	<b>Clean Audit</b>
2009/2010	9%
2010/2011	7%
2011/2012	17%
2012/2013	36%
2013/2014	55%

## APPENDIX 3

### Data on tools of governance (Internal Audit, Audit Committee and Risk Management)

#### Tools of Governance (Internal Audit, Audit Committee and Risk Management) Eastern Cape

Year of reporting	Internal audit	Audit committee	Risk management
2009/2010	5%	6%	9%
2010/2011	16%	24%	7%
2011/2012	13%	10%	12%
2012/2013	2%	0%	2%
2013/2014	4%	4%	4%

#### Free State

Year of reporting	Internal audit	Audit committee	Risk management
2009/2010	15%	5%	0%
2010/2011	10%	10%	2%
2011/2012	19%	15%	8%
2012/2013	4%	4%	4%
2013/2014	0%	11%	0%

#### Gauteng

Year of reporting	Internal audit	Audit committee	Risk management
2009/2010	71%	71%	52%
2010/2011	51%	83%	83%
2011/2012	16%	19%	52%
2012/2013	32%	59%	32%
2013/2014	63%	84%	63%

### Kwa-Zulu Natal

Year of reporting	Internal audit	Audit committee	Risk management
2009/2010	59%	52%	54%
2010/2011	69%	61%	64%
2011/2012	50%	49%	50%
2012/2013	45%	43%	45%
2013/2014	71%	69%	71%

### Limpopo

Year of reporting	Internal audit	Audit committee	Risk management
2009/2010	15%	8%	14%
2010/2011	7%	3%	4%
2011/2012	3%	3%	3%
2012/2013	4%	4%	4%
2013/2014	6%	13%	6%

### Mpumalanga

Year of reporting	Internal audit	Audit committee	Risk management
2009/2010	39%	51%	39%
2010/2011	25%	23%	40%
2011/2012	16%	21%	32%
2012/2013	14%	19%	14%
2013/2014	16%	22%	16%

### North West

Year of reporting	Internal audit	Audit committee	Risk management
2009/2010	7%	0%	3%
2010/2011	4%	4%	1%
2011/2012	0%	0%	1%
2012/2013	0%	0%	0%
2013/2014	0%	0%	0%



### Northern Cape

Year of reporting	Internal audit	Audit committee	Risk management
2009/2010	8%	9%	11%
2010/2011	11%	10%	8%
2011/2012	0%	14%	14%
2012/2013	14%	18%	14%
2013/2014	31%	21%	31%

### Western Cape

Year of reporting	Internal audit	Audit committee	Risk management
2009/2010	48%	60%	56%
2010/2011	49%	49%	42%
2011/2012	50%	46%	56%
2012/2013	47%	53%	47%
2013/2014	72%	68%	72%