

## Effects of an Audit Opinion on the Operations of a Municipality in a Developing Economy

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**Abstract:** This study investigates how audit opinions affect the operations of municipalities in South Africa. The study is premised on the principal-agent theory, where the municipal council and management act as agents and the stakeholders as principals. Municipalities are mandated to execute the national development plans of the government in power. Their main task is service delivery to the citizens residing within their area of jurisdiction. Thus, municipalities do not seek to make a profit. The Municipal Council forms part of the management of the municipality, and governs it in line with the mandate prescribed by provincial and national government, as well as the country's constitution. A self-administered questionnaire was used to gather data. The study found that the municipal employees are aware of audit findings and indicate that qualified audit findings have an adverse impact on the operations of the municipality. The study offers insight into the services provided by external auditors that add value to municipality operations and ensure sound governance, efficient financial record-keeping, and also reporting thereon. The study concluded that an audit that is relevant to an entity's objectives rather than a standard, tick-box exercise, would enable municipalities to achieve their objectives and thus provide policy-makers with useful information to inform policy formulation and implementation.

**Keywords:** audit; governance; government; municipality; opinion

### 1. Introduction

The discourse on the role of auditing within the public governance framework is ongoing, as scholars and practitioners seek lasting solutions to the principal-agent problem. This problem is a trade-off where owners of businesses or providers of capital employ agents to manage the business on their behalf in terms of a contract

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signed between the two parties (Truong & Trück, 2016). Auditing costs form part of the agency costs incurred by organisations in trying to mitigate the agency problem (Falkman & Tagesson, 2008). Agency costs are incurred by both public and private sector organisations (Andersson & Rebecka, 2011), which appoint auditors “to provide reasonable assurance about whether the financial statements as a whole are free from material misstatements” (IAASB, 2012, p. 74). While corporate governance reports like the Cadbury Report and King Reports (I to IV) set the framework for sound governance, very little research has been conducted on how audit opinions affect the operations of organisations (Dumay, 2016). This is particularly true in the public sector where, unlike the private sector, the objective is to fulfill the constitutional mandate of improving citizens’ lives (Scholtz, 2014; Mpehle & Qwabe, 2008). It is within this discourse that this study seeks to establish the effects of audit opinions on the operations of municipalities in South Africa.

Chapter 9, section 188 of the South African Constitution requires all municipal entities and government departments to undergo an audit by the Auditor General of South Africa (AGSA) on an annual basis (South African Government, 2013). The purpose of an audit is to report on the financial statements of an entity, detailing whether they are free from material misstatements due to fraud or error – and with the overall aim of ensuring such statements are credible (Kachelmeier et al., 2017). The AGSA thus reports on the accounts, financial statements and financial management of municipal entities.

Since audits are a statutory requirement, municipalities cannot escape this process and they aspire to an unqualified opinion (clean audit) (Maclean, 2014). External audits that are tailored to the needs of municipal or local government entities could result in improved management. In the private sector, audited financial statements are highly valued as they provide stakeholders with a reasonable assurance that the financial statements are credible. In this sector, business owners often hire or appoint agents (management) to run their companies (Notshikila & Govender, 2014). Therefore, management would want to ensure that the controls, strategies and operational policies of the businesses they manage result in an audit opinion that shows that they have performed well as agents. In cases where the auditors identify issues or concerns, management is inclined to implement new policies or enforce existing ones to address such matters (Kachelmeier et al., 2017).

This study examines the effects of audit opinions on the operations of Mpofana Local Municipality during the financial periods ending 30 June 2014, 2015 and 2016.

While local authorities in KwaZulu-Natal have had a fair share of qualified audit opinions, very little attention has been paid to the effects of such opinions on their operations. The constitution mandates municipalities to provide services to residents within their jurisdiction and to improve living standards. Given the large number of municipalities in KwaZulu-Natal, this study used Mpofana Local Municipality as a case study.

## **2. Literature Review**

An audit is a methodical and independent examination of any subject matter (Ittonen, 2010). In business, it refers to an audit of “books, accounts, statutory records, documents and vouchers of an organization to ascertain how far the financial statements as well as non-financial disclosures present a true and fair view of the business or organization” (Notshikila & Govender, 2014, p. 6). Furthermore, an audit aims to ensure that the books of accounts are properly maintained by management and those charged with governance – as required by law (Loughran, 2010).

Auditing is important in the corporate world and the public sector, as it provides assurance to various stakeholders that the subject matter is free from material misstatement (Ittonen, 2010). The term “audit” is frequently applied to audits of financial information relating to a legal person. The auditor interprets and recognises the propositions before them for examination, obtains evidence, evaluates same, and formulates an opinion based on his/her judgement, which is then communicated via the audit report (Notshikila & Govender, 2014).

### **2.1. Theoretical Framework**

Auditing dates back to the 1800s, when it mainly revolved around confirmation of whether a certain client or auditee had complied with a specific law or accounting standard. However, in the past 30 years it has evolved into a value-add service that provides reasonable assurance to stakeholders or those that engage the services of auditors (Teck-Heang & Ali, 2008).

The purpose of the audit process is communication between the organisation and its environment. Theories of auditing provide a platform to understand the laws and regulations underpinning the audit process and its activities (Ittonen, 2010). Audit opinions have implications for how municipalities provide services to the residents within their area of jurisdiction. Hence, governance is the main reason why organisations employ auditors. Four theories of Auditing are discussed and are as

follows: the Policeman Theory, the Lending Credibility Theory, the Theory of Inspired Confidence, and the Agency Theory (Ittonen, 2010).

The Policeman Theory posits that the main purpose of auditing is to detect errors or issues in the financial statements in order to reduce the auditor's risk to an acceptable level. The risk referred to is that the auditor might express an incorrect audit opinion. This theory found expression in auditing standards that govern the auditing of any client or engagement. In terms of this theory, auditors are expected to express an opinion on whether the financial statements are free from material misstatements due to error or fraud.

The Lending Credibility Theory states that an audited set of financial statements is credible, so increasing stakeholder confidence in the organisation.

The Inspired Confidence Theory notes the need for increased accountability on the part of those that initiate record and report transactions. Auditors' services are required because the management of a business might not necessarily be the owner. Third parties that have an interest in the results of the business will have more confidence in such results when they receive an audited set of financial statements.

Finally, the Agency Theory states that a business engages in several transactions governed by contracts with suppliers, debtors, and employees that management enters into as agents of the principal – the owners of the business that invest funds in the entity (Ittonen, 2010).

## **2.2. Empirical Literature**

In considering the operations of a municipality, there is a need for good governance – especially in the public sector. A nation's governance status is a key determinant of foreign aid from the international community (Kulshreshtha, 2008; Brinkerhoff & Brinkerhoff, 2015; Acht et al., 2015). Studies have shown that countries with poor governance structures tend to receive less state-to-state aid due to inefficiencies within the public sector (Acht et al., 2015). Donors and institutions in the international community – such as the World Bank, United Nations Development Programme (UNDP), Organization for Economic Co-operation and Development (OECD), and World Trade Organization (WTO) – have advocated good governance among member nations. This has stimulated academic researchers' interest in the issue of good governance in the public sector. Fukuyama (2013) defines public sector governance as the ability of government to legislate and execute rules, while

delivering services regardless of the nature of the political structure. This perspective of governance relates to an infrastructural rather than a political perspective.

On the other hand, Rose-Ackerman (2017) approaches good governance from an “anti-corruption” perspective and posits that it involves the legitimacy of public-sector structures and effective, substantive results. This perspective was motivated by the negative impact of corruption and the desire to promote public participation in executive policy-making.

The World Bank definition of good governance remains the gold standard. The World Bank Experience identifies the following four pivotal qualities of good governance (Williams & Young, 1994; Fukuyama, 2017):

- A structure epitomised by predictability, openness, and enlightened policy-making;
- A bureaucracy imbued with a professional ethos;
- An executive arm of government accountable for its actions; and
- A strong civil society participating in public affairs, with all being under the rule of law.

However, some studies have shown that the effectiveness of governance is often at odds with the diverse objectives that the governance structure seeks to accomplish (Fukuyama, 2013; Mutiganda, 2013; Faguet, 2014). Fukuyama (2013) supports this viewpoint via the agency theory, which describes governance as a subsisting relationship between the agent and his/her principal. Fukuyama thus argues that governance within the public sector is about the performance of agents (public officers), who are assigned the responsibility of carrying out the wishes of the principals (the citizenry).

Andersson and Nilsson’s (2011) study in Sweden investigated whether audit reports on municipalities focus on historical financial information/results or on their performance. The study found that audits now include a review of the municipality’s performance – provided the government defines relevant performance measures. However, it also found that the audit report still focuses on financial results. In this study, performance was defined in terms of how efficient (converting inputs to outputs), effective (meeting the goals initially set) and adaptable a council is, in achieving its financial goals. A performance review is important, because municipalities are not necessarily concerned with making a profit, but use taxpayers’ funds to provide services to the general public/residents or citizens falling within

their area of jurisdiction. Performance audits are thus a tool to enhance accountability.

While public-sector governance has witnessed several reform processes over the years at national and sub-national levels, Zulu (2006) exacts that it is important to evaluate their adoption at municipal level. Germany adopted the NPM model in local government in order to modernise this level of government. The so-called New Steering Model was a German adaptation of the public management model adopted by the city of Tilburg in The Netherlands. Due to its success, it became a template for public sector modernisation across German local government (Bauer & Steurer, 2012).

On the other hand, governance for performance is output-driven – rather than focusing on the inner workings of the organisational structure (Mutiganda, 2013). It promotes accountability of the agents tasked with specific responsibilities based on established qualitative and quantitative performance indicators. While performance metrics are easily measured in the private sector, where the balanced scorecard is widely used, Arnaboldi et al. (2015) note that performance management has been a key issue in the public sector, especially at municipal level, due to measurement difficulties. They add that this issue is further complicated by the negative effects that a poor performance management system tend to have on the morale of public officers.

Governance for mission is common among public institutions and not-for-profit organisations. Klijn and Koppenjan (2015) state that it is kick-started by interaction between the actors and stakeholders that are part of the mission to deliberate and agree on the generic objectives that the mission seeks to represent, and give direction and motivate actors to execute the mission statement (Klijn & Koppenjan, 2015). Klijn and Koppenjan (2015) suggest that an “open agenda” would be necessary for the actualisation of the mission, as this will give the actors/executors the opportunity to “voice their opinions” and perspectives that are necessary for formulating the problem, setting policy, and establishing key service areas within the public sector).

Although studies on audit have been carried out, it is evident that performance of the auditee has been the focus. The next section discusses the methodology used in this study.

### **3. Methodology**

A quantitative research approach was employed to determine the effects of an audit opinion on municipalities in KwaZulu-Natal Province, South Africa. The study design was exploratory in nature, with a case study employed to answer the research questions. A case study involves a systematic inquiry into an event or set of related events – in order to describe and explain the phenomenon of interest (Notshikila & Govender, 2014).

KwaZulu-Natal local government, which was the population for the study, comprises 54 municipalities – including one metropolitan municipality, 10 district municipalities and 43 local municipalities. As of 2015, the province had 61 municipal entities. In August 2016, 12 municipalities merged, so creating five new municipalities, while others were annexed to existing municipalities. There are now 54 municipalities in the province. The restructuring aimed to improve the use of resources, as some municipalities had become non-viable. Municipalities in existence at 1 April 2017 were part of the study population. Cluster sampling was used initially to categorise the municipalities in terms of audit opinions for the financial year 2013/2014.

The categories were: municipalities with a “clean audit opinion, unqualified audit opinion with findings, qualified audit opinion, adverse audit opinion and a disclaimer of the audit opinion” (AGSA, 2017). The AGSA General Report (AGSA, 2014) was used to gather this information. The base year was the 2013/2014 financial year. A questionnaire was used to gather the primary data. The questionnaire had 29 questions divided into four themes; biographical information, the effects of an audit opinion on the operations of Mpofana Local Municipality, Audit Implementation Plan on the operations of Mpofana Local Municipality and impact of audit opinions on service delivery in Mpofana Local Municipality. Data collected were coded and analysed using the Likert scales. The data were imported into an Excel spreadsheet, and then into the Statistical Package for the Social Sciences (SPSS) version 25 for analysis. Descriptive statistical analysis was used to calculate the mean, standard deviation and range of scores for the dependent and independent variables (Creswell, 2013). As suggested by Alversia (2011), frequency distribution, chi-square and cross tabulation was used to analyse the data.

#### 4. Findings

Fifty-two of the 79 questionnaires distributed were returned, representing a 66% response rate. The relatively high response rate is in line with expectations of paper-and-pencil survey types, which produce higher response rates (Hardigan, Succar & Fleisher, 2012). Table 1 (below) shows that most respondents (51%) possess a diploma:

**Table 2. Respondents' qualifications**

Qualification	Matric	Certificate	Diploma	Degree	Postgraduate
Proportion (%)	12.2	16.3	51.0	14.3	6.2

While some of the respondents (12%) do not have any post-secondary qualification, only 6% have a postgraduate qualification. This is consistent with Caillier's (2014) study that found that government employees in South Africa mainly have post-secondary qualifications.

Table 2 (below) shows that the respondents' job levels range from senior management to administrator:

**Table 3. Respondents' levels of employment**

Category	Responses	Percent
Supervisor	3	6.3
Senior Management	4	8.3
Top Management	1	2.1
Executive	2	4.2
Administrator	38	79.2
<i>Total</i>	48	100.0

Of the respondents, 39% had been employed in their current position for at least five years, while 27.5% indicated that they had occupied their position for less than a year.

Furthermore, 14% of administrators had matric, 19% a diploma and 11% a degree. All the respondents in senior management positions, including top management and the executive, possess at least a diploma. James's (2014) study produced similar results in relation to government departments.

The next section presents the results from five questions relating to the effects of an audit opinion on the operations of Mpofana Local Municipality – particularly in terms of communication. The Cronbach's Alpha for these items was 0.904. Table 3



(below) presents a summary of the results. The descriptive statistics cover frequency (in percentage), and mean and standard deviation based on the Likert scale.

**Table 4. Summary responses for questions 5 to 9**

<i>Communication</i>	Strongly Disagree	Disagree	Uncertain	Agree	Strongly Agree	Mean	Standard Deviation
I am aware of the municipality's audit findings.	7.8	3.9	11.8	35.3	41.2	3.98	1.191
The municipality communicates audit findings to municipal departments.	5.8	11.5	9.6	36.5	36.5	3.87	1.205
I understand the different types of external auditors' opinions.	6.0	4.0	10.0	36.0	44.0	4.08	1.122
I am aware that Mpfana Local Municipality had a qualified opinion with findings for the year ended 30 June 2014 and 30 June 2015.	7.8	9.8	3.9	39.2	39.2	3.92	1.246
I am aware that Mpfana Local Municipality had a disclaimer of audit opinion for the year ended 30 June 2016.	9.8	3.9	5.9	41.2	39.2	3.96	1.232

Fifty-one respondents answered question 5, with 76.5% agreeing that they were aware of the municipality's audit findings and a mean of 3.98 – suggesting strong assertion of this statement. Of interest is the large number of respondents (41%) that strongly agreed that audit findings were made known to municipal employees.

The mean of 4.08 in question 7 indicates that the respondents agreed that the audit findings are clearly understood by Mpfana Local Municipality's employees. Furthermore, most of the respondents indicated that they were aware that the municipality had a qualified opinion with findings for the year ended 30 June 2014 and 30 June 2015, and a disclaimer in the June 2016 audit.

Cross-tabulations and correlations were employed to test for any significant relationships between the variables. The correlations between question 2 (highest qualification) and question 8 (I am aware that Mpfana Local Municipality had a qualified opinion with findings for the year ended 30 June 2014 and 30 June 2015) produced statistically insignificant results. This suggests that an employee's

qualifications do not impede them from being aware of the municipality's audit findings.

### Employee perceptions of audit opinions

Table 4 (below) presents the data on questions 10 to 12 of the questionnaire.

**Table. Employee perceptions of audit opinions**

	Strongly Disagree	Disagree	Uncertain	Agree	Strongly Agree	Mean	Standard Deviation
I feel that qualified audit opinions issued in 2014 and 2015 and a disclaimer of audit opinion in 2016, have led to reduced effectiveness of the municipality's operations.	6.0	12.0	14.0	44.0	24.0	3.68	1.151
I feel that audit opinions negatively affect the municipality's financial activities.	13.7	11.8	11.8	37.3	25.5	3.49	1.362
As an employee of the municipality, I feel the audit opinions negatively affect my morale at work.	21.6	5.9	7.8	39.2	25.5	3.41	1.486

Of the respondents, 10,68% agreed that qualified audit opinions issued in 2014 and 2015 and a disclaimer of audit opinion in 2016, reduced the effectiveness of the municipality's operations. This assertion is quite strong, as shown by the mean of 3.68 and standard deviation of 1.151. The respondents also indicated that audit opinions negatively affect the municipality's financial activities and their morale at work. These results are consistent with Zulu's (2006) study that found that municipalities in South Africa do not have defined policies and procedures to address the audit issues raised – especially in relation to risk management. However, the correlations did not reveal any relationship between job level and employee morale. This suggests that job level does not influence employee morale at the municipality.

Different types of audit opinions issued to the municipality. Such knowledge and awareness was not determined by their qualifications or technical knowledge. The respondents were also aware of the audit findings that accompanied the opinions issued in the years 2014 to 2016, as the results indicated that the opinions and findings were communicated to the municipality's employees. They felt that the negative audit opinions impacted negatively on municipal operations, financial activities, and also staff morale. This suggests that the results and feedback do not always impact positively on the auditee (Ivers et al., 2014).

## 5. Conclusion

This study examined the effects of audit opinions on the operations of Mpofana Local Municipality during the financial periods ending 30 June 2014, 2015, and 2016. The study revealed that municipal employees are aware of the duties of external auditors and the different types of audit opinions they issue. The municipality communicates the audit findings to all internal stakeholders, who participate in the formulation of an action plan to address the findings that led to a qualified, adverse or disclaimer of audit opinion. This study aimed to improve all municipal employees' understanding of the services provided by external auditors, which are not necessarily aimed at policing but adding value to municipality operations to ensure proper governance, the capturing of financial records, and the reporting thereof. The study will also enable policy-makers to understand that an audit needs to take different organisational needs into account – rather than just being a blanket standard, tick-box exercise that is applicable regardless of the nature of the entity's business. It is recommended that further research be conducted on the link between the audit opinion and service delivery or performance review (performance management systems) within a municipality – in order to establish whether the performance review results are congruent with those of the external auditors.

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