The effect of governance on clean audits in South African municipalities

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ABSTRACT

This article examines the effect of governance on the degree to which clean audits have been achieved in South African municipalities. Its pertinence lies in the context of two endemic public management performance weaknesses, namely, the elusive target set by the COGTA and Auditor-General to achieve clean audits in all South African municipalities by 2014, and the ubiquitous service delivery failures in South African municipalities. These failures are now widespread and apparently negates the national goal of an inclusive socioeconomic development process for the country. Thus, the article makes a contribution, by identifying cost-effective measures for improved governance (and subsequent improved audit outcomes), by addressing the seeming scarcity of empirical investigation into the effect of governance on the achievement of clean audits. The methodological approach employs a panel data study of audit performance of all municipalities in South Africa hence, a quantitative approach – the panel data regression analysis, was used to analyse the data The data comprises the Auditor- General of South Africa's (AGSA) consolidated annual municipal reports for the financial years 2009/10 to 2013/14 for the country's nine provinces. The data was retrieved from the AGSA's archives of consolidated municipal audit reports. A panel data analysis gave a total of 45 observations which were subjected to regression analysis. The statistical findings show that quality of governance significantly affects the achievement of a clean audit at a significance value of $P < 0.02$. This finding suggests that a declining

effectiveness in governance may well have played the key role in derailing the public sector's intended journey to universal clean audits by 2014. In its conclusion this article recognises the need to evaluate the specific effectiveness of governance relative to the impact of the other variables that were understood to affect clean audit, namely financial management and leadership. Furthermore, this article identifies the major variables within governance that underlie and drive its key position, in the hope of guiding the AGSA in directing resources most effectively.

INTRODUCTION

It goes without saying that the presence of an effective governance function is important for overseeing and ensuring *clean administration*. Thus, the clean audit outcome is an essential indicator of a well-functioning or clean administration within public sector organisations (Department of Cooperative Governance and Traditional Affairs (COGTA) 2009). Throughout South Africa's public sector organisations, the talk has been of how to achieve a clean audit outcome, and of how governance could enhance the processes required to achieve that outcome (Deloitte 2012; National Treasury 2014). It is also widely accepted that effective governance increases the efficiency and effectiveness of the organisation, ultimately making the clean administration objective a reality (AGSA 2011/12; Makhura 2014). Effectively, the role of governance is to optimise the use of resources through ensuring proper internal control systems (Cao, Li & Zhang 2015; Lisic, Neal, Zhang & Zhang 2015). Thus, where there is proper governance, this translates as responsibly-spent public funds and the successful delivery of services. Conversely, poor governance correlates with wasted or stolen public funds which manifests as non-delivery of basic services to the community. Arguably, good governance can be equated with clean administration, which naturally emerges when governance is effective. The fact is that *clean administration* has proved effective in improving the functioning of local government entities (Soomro & Chandio 2013), and should be pursued in the South African context so as to provide the impetus to achieve public sector-wide clean audit outcomes.

According to Matziliza (2013) and Deloitte (2012), good governance shapes the attitudes of the stewards of public or shareholder resources, by encouraging them to commit themselves to high standards of integrity and ethical values, and to pursue clear and effective communication. This requires appointing officials with appropriate qualifications, competencies and work ethics. Hence, a well governed administration is built by strengthening 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 procedures; and, ensuring fair participation in politics, and by participating in international cooperative efforts (Ma 2008). Thus, a clean government administration is one that puts the principles of the Constitution, 1996 into daily use; that ensures there is no corruption or abuse of power, and that it is responsive to the needs of its citizens.

The objective of this article is therefore to evaluate the contribution of effective governance to the achievement of clean audits in South Africa's municipalities. The next section of this article provides a brief review of literature on the concepts of governance and stewardship. Thereafter, the research methodology is presented, followed by an analysis and discussion of the data, and the limitations of the study. The final section provides conclusions and recommendations.

GOVERNANCE AND AUDITS IN THE PUBLIC SECTOR

Almost all public sector organisations currently state that promoting good governance is an important part of their strategic direction and agenda. Thus, the relationship between governance and the achievement of clean audits in South African municipalities can be seen as a reflection of the municipalities' commitment to good governance. Similarly, good governance is achieved when the public representatives are held accountable for the use of the public funds entrusted to them, and for the properly approved procurement and implementation of services like health care, education and infrastructure, all of which are intended to benefit the citizens by creating stability and inspiring confidence in the way tax payers' money is being spent (Meyer 2015). Ultimately, therefore, governance implies accountability (Andersen 2015; Zadek & Radovich 2006; Van den Berghe 2009; Bekiris 2013).

Despite the dominant view that good governance enhances accountability, Grindle (2004:525) observes that governance structures and processes could be challenged when government and its employees perform poorly; that is, when resources are wasted, and prescribed services are not provided regularly, if not at all. Additionally, the absence of good governance invariably results in catastrophic audit outcomes (Deloitte 2014). According to the AGSA (2014), and the Presidency (2014), South African municipalities all face similar challenges. These challenges are deep-rooted and are the result of a generally poor understanding of governance and pieces of legislation related to administrative systems, and an associated unwillingness to apply better processes of governance (AGSA 2014; the Presidency 2014). Poor audit achievements are therefore inevitable.

It is important to recognise that the effect of governance on the achievement of clean audits lies in its ability to coordinate processes, and requires various stakeholders to respond to the policies of government in a positive manner. Thus, governance tools such as audit committees (Morrell & Kopanyi 2014; Boyle, Gramling, Hermanson & Hermanson 2015), independent internal audit functions (Gramling, Maletta, Schneider & Church 2004; Arena & Azzonne 2009; IIA 2012), and external audits (Brennan & Kirwan 2015) and risk management processes (IOD 2009; National Treasury 2014), which have all been (nominally) implemented in the South African public sector over the past two decades, should have yielded a wide range of encouraging and positive consequences to speed up service delivery. Despite the particular relevance of these governance tools in the South African public sector (they are mandatory requirements contained in the *Local Government: Municipal Finance Management Act*, 56 of 2003 (RSA 2003) and the *Public Finance Management Act*, 1 of 1999 (RSA 1999), clean audit outcomes remain largely elusive. Since governance is incidental to service delivery and hence clean audit, Morrell & Kopanyi (2014), it is therefore pertinent to review the concept of governance in the following section.

Governance

Academic literature on 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 those entrusted with the utilisation of public resources should be responsive to the needs and interests of the communities they serve, and accountable to the same bodies.

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). Furthermore the concept of governance is also a neutral term embracing the complex mechanisms, processes, relationships and institutions through which individual 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).

The concept of governance was referred to by many individuals and organisations in the private sector, public sector and other formal and informal organisational structures for many years (Graham, Amos & Plumptre 2003:6) before gaining sufficient clarity of a 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 other objectives (Andersen 2015; Van den Berghe 2009; Fasenfest 2010).

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 Committee on Corporate Governance* (three reports and codes have been issued to date, with King IV published in 2016) (IOD 1994; 2002, 2009). Because public sector organisations have long been required to be compliant with the core recommendations in these reports, they are by now 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 achieve its goals independently of the power of government to command or use authority.

Hence, Stoker 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 (Jørgensen & Sørensen 2012; Begum, Uddin, Chowdhury, & Hamiduzzaman 2014). 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 implicit 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 practising accountability (Zadek & Radovich 2006; Van den Berghe 2009; Bekiris 2013; Andersen 2015). Accountability is the key component of good governance. Unfortunately, in South Africa within the last two decades 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 in the Northwest Province, two in the Free State, three in the Eastern Cape, two in Mpumalanga and four in Kwazulu-Natal. The details of their poor governance abilities originate in their financial and administration departments; in parallel, 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 lines 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; Van den Berghe 2009; Andersen 2015) to the wellbeing of the entity and its stakeholders. It should be stressed here that a numerical ranking on effective (or good governance) and weak (or bad governance) is done by the Auditor-General of South Africa during the annual municipal audit; this numerical ranking is thus applied in the analysis of data under the methodology section. Hence it is expected that good governance ranking would pilot the municipalities to higher achievement of clean audit, but bad ranking would achieve the contrary.

Stewardship Theory

Stewardship is 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). 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 (Waters 2013). Hence, politicians and government administrators are alike entsrusted with the care of the nation's resources placed under their control during their tenure of office. Thus, good stewardship is best demonstrated through responsibility in the management of public resources.

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 demonstrate the knowledge and skills required for managing 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. Therefore, in the context of this article, stewardship is essential to facilitate good governance, which thus yields clean audit when public resources have been applied transparently to supply public goods to the citizens. Thus, stewardship theory informs the discussion of governance literature in this article and subsequent application of causal methodology to examine the extent to which effective governance (based on efficient stewardship) has led to the achievement of clean audit in South African municipalities.

Stewardship

In the South African public sector, accountability is required from the stewards of the public purse in terms of the *Constitution of the Republic of South Africa,*1996 (RSA 1996), the *Public Finance Management Act*, 1 of 1999 (RSA 1999), and the *Local Government: Municipal Finance Management Act,* 56 of 2003 (RSA 2003). Stewardship 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 equally entrusted with the care of the nation's resources that have been placed under their control for the duration of their tenures in office. Thus, the entrusted responsibilities can be removed by the communities, if the stewards are not accountable and/or 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 the removal of such stewards has been left, increasingly, to the undiscriminating and violent actions of the previously ignored (local resident) principals. Thus, as good stewardship is best demonstrated through the exercise of one's responsibility in the management of public resources, it is possible that the service delivery protests might have been avoided if the second and first sphere authorities had responded more effectively and timeously to their third sphere colleagues' challenges, since municipal structures are widely seen as the operational and delivery ends of national government policies.

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-Metcalfe & Alimo-Metcalfe (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 is used to frame the literature review of the financial and non-financial aspects of accountability. Thus, Shah (2006:22) identifies the basic principles of local governance as "responsive governance, responsible governance, and accountable governance" that could assist governments to do the right things in delivering services consistent with citizen preferences.

In terms of the King Code of Governance Principles and the King Report on Governance in Southern Africa (King III) (IOD 2009), stewardship in local government, an organisation is expected to act with intellectual honesty, exercise accountability in decision-making, be committed and courageous, and also demonstrate the knowledge and skills required for governing local government entities effectively. Thus, Mazibuko & Fourie (2013) recognise that mayors, municipal managers, councillors and officials have the greatest responsibility to demonstrate good stewardship and accountability. Therefore, governance as a key structure, plays an important role in ensuring the maintenance of a balanced view of the municipality's strategic direction.

METHODOLOGY

Having outlined the theoretical argument underpinning this article, this following section presents the quantitative research method followed. The research used a panel data analysis method to determine the degree to which governance impacted on the achievement of clean audits in South African municipalities. The data comprised a purposive sample of audit outcomes from all municipalities in South Africa (broken down per province) for the five year period preceding the target set by the national government (through the Department of Cooperative Governance and Traditional Affairs), that by the 2013/14 financial reporting period all municipalities should receive clean audit outcomes (COGTA 2009). Data was collected from the AGSA's website on the effect of governance on clean audit outcomes. The design of the study follows a causal research approach in which the effects of specific assumptions are measured together with how they relate to each other (Brewer & Kubn 2010). Thus, secondary data was used to measure the effect of governance on the achievement of clean audits in South Africa over the five financial years between 2009/10 to 2013/14. Data analysis comprised a multiple regression approach and was used to identify the effect of governance on clean audit outcomes. The reliability and validity of the fitted regression model were assessed through the use of a heteroskedasticity correlation test.

EFFECTS OF GOVERNANCE ON CLEAN AUDITS

This is one of the few studies conducted that follows a causal research design to measure and evaluate the effect of governance on the achievement of clean audits in South Africa. The following tables present the panel data regression results identifying the determinants

Table 1: Dependent variable: leadership [Led], financial management [FinMgt] and governance [Gov]

	Coefficient	Std. Error	t-ratio	p-value	
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					

Table 2: 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

Table 3: 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: $y = a + b_1x_1 + b_2x_2 + e$ Thus, ^CLAud = –0.00397 –0 .0872*Led + 0.184*FiNMgt + 0.190*Gov			

of the achievement of clean audits with specific reference to governance as a significant variable. Tables 1 to 3 present panel data regression results on determinats of clean audit in South African municipalities; and they provide the Heteroskedasticity-corrected model, using 45 observations.

As shown in the above Table 2, 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%). I.e., F = 16.67807 and *P* = 0.000<0.05. This implies that, because the resultant significance level of 0% is less than the 0.05 ceiling, therefore the joint relationship between leadership [Led], financial management [FinMgt] and governance [Gov] on the one hand, and clean audit [CLaud] on the other, is highly significant. Thus, these are drivers of clean audit achievement.

Findings shown in Table 1 indicate that the predictive effect of governance is significant in determining progress to 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, indicates that, unlike the other variables, when analysed individually governance's effect on progress towards the achievement of clean audits remains 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 in municipalities, 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 preceding discussion about governance indicate that governance does have a positive relationship with progress to the achievement of clean audits in South Africa's public sector entities. 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 supporting 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, and this effect is significantly greater than that exerted by 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 the aspects or constituents of governance such as internal audit, risk management and the audit committee (when present and fully functional), have played an immense role in boosting the strength of governance in the South African public sector, by influencing audit outcomes positively. However, the picture is not nearly as positive when looking at the results for the remaining independent variables. These will be discussed in a future article.

LIMITATIONS OF THE STUDY

The study was limited in that it drew on data for a specific and significant five year period ending at the end of the 2013/14 financial reporting period. During this period there was significant pressure on municipalities to achieve clean audits. However, as the audit results continue to show, the efforts have not been significantly rewarded. The South African Department of Cooperative Governance and Traditional Affairs has now ceased putting pressure on municipalities and has extended the target date for the achievement of country-wide municipal clean audits. It is yet to be researched whether this will have any effect on the number of clean municipal audits achieved in the future.

CONCLUSION AND RECOMMENDATION

This article evaluated the effect of governance on the achievement of clean audits in South African municipalities. The empirical analysis discussed in this article shows that within the South African municipal setting, governance plays an important role in ensuring the effective running of the municipalities, and this result thus meets the objective. This article, therefore, concludes that there is a significant relationship between governance and the achievement of clean audit outcomes in South African municipalities.

The article was a response to the call made in 2009 by the national government for the achievement of clean audits within a five year period. The research also considered the many discussions and assertions that were made on how the municipalities would need to change in order to achieve this target. As a result of an examination of the formal audit processes it became apparent that the three key elements (leadership, financial management, and governance) chosen by the AGSA as essential to achieve the improvements necessary to make such a call reality were more or less correct. However, the detail in the analysis essentially endorsed findings in the review of recent literature that reveal that it is primarily governance equated to accountability. This article confirms that it is governance that has the most significant relationship with clean audit achievement. The article, therefore, recommends that governance structures should be encouraged to play their role of advising the municipal officials more effectively, particularly in getting municipalities to address the audit queries and the service delivery challenges in order to realise the goal of achieving clean audits. Finally, the article opens up further avenues of research into the extent to which governance variables (such as internal audit, risk management and the audit committee) can affect the achievement of clean audits.

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