

## **AUD010 The influence of public sector audit committees on external audit outcomes: case study evidence from an Eastern Cape municipality**

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### **Abstract**

Audit committees have become an important feature of corporate governance in the public sector due to concern about poor external audit outcomes in municipalities. The purpose of this paper is to examine the influence of audit committees on external audit outcomes in the public sector, specifically Eastern Cape municipalities. This study examines the process followed by audit committees to fulfil their oversight role by way of a case study of a municipality that has shown marked improvements in its external audit outcomes. Semi-structured interviews were conducted with the audit committee members, management and members of the internal audit team. It was found that the audit committee has an influence on external audit outcomes. Using the institutional theory, it was found that audit committee members strive to provide effective monitoring of financial reporting rather than being ceremonial. However, the influence of the audit committee is not as strong as that of municipality administrative leadership tone, with management rating the influence at 40% and 60% respectively. The study cannot be generalised as this was a case study on one municipality.

**Key words:** corporate governance, audit committee process, audit outcomes

### **1. Introduction**

Eastern Cape municipalities have been faced with poor audit outcomes. According to the Auditor General of South Africa (AGSA 2013), only 20% of municipalities in the Eastern Cape received unqualified audit reports for the 2012 financial year. The Auditor General (AGSA) identified the cause of the problem to be significant weaknesses in internal controls. The Municipal Finance Management Act 56 of 2003 requires every municipality to appoint an audit committee (AC). The AC performs responsibilities as assigned to it by the Municipal Finance Management Act (MFMA). These responsibilities of the AC include providing assurance on the credibility of various reports produced for oversight, decision-making and accountability purposes. Should the AC fail in executing this responsibility effectively, vital decisions relating to the funding, accountability and service delivery will be based on information that may be inaccurate, incomplete and unreliable.

This study examines how and to what extent ACs influence external audit outcomes by focusing on a municipality in the Eastern Cape that improved its audit outcome markedly. The institutional theory (Spira 2002) will be used as an interactive process of data collection and analysis in this study. This theory suggests that it is necessary to understand the substance of the interactions between different governance parties and how these parties use,

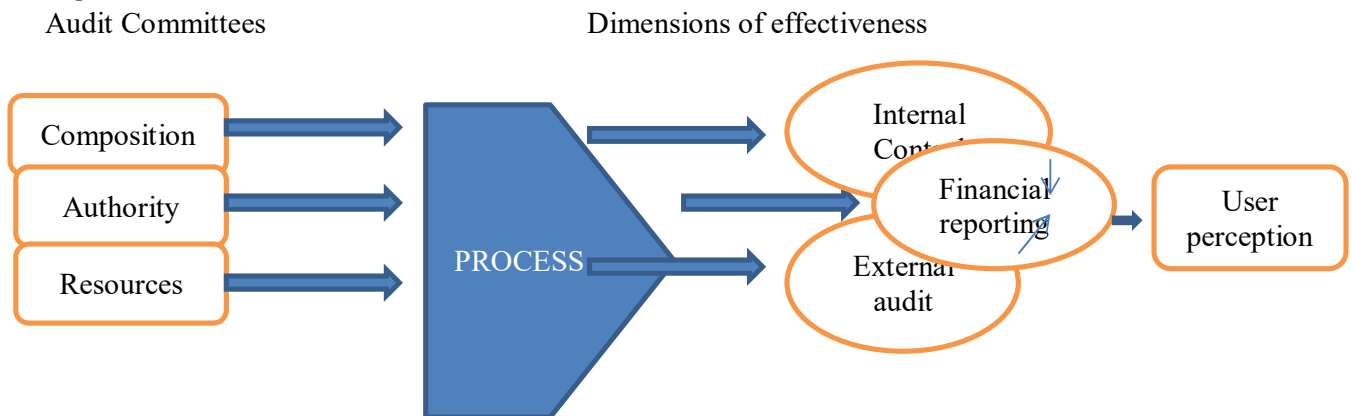
at times, ceremonial activities to maintain their form to all relevant parties. Therefore, this study will examine whether the AC process is substantive and will influence management decisions that affect the control environment or merely ceremonial where the AC's actions will suggest existence with no real influence. An improvement in the control environment will result in improved external audit outcomes. The case study approach is the most appropriate research strategy for this study because of its advantages in revealing in detail the unique perceptions and concerns of individual participants in a real-world situation which would be lost in quantitative or experimental strategies (Thomas 2011). We find that AC members strive for effective monitoring and do not want to serve on ceremonial ACs. There are, however, some ceremonial actions that have been identified.

## 2. Literature review

### 2.1 Introduction

In general, the regulators' goal for the AC is to enhance the quality of financial information and maintain confidence in the quality of financial reporting. The AC can improve the quality of information directly by overseeing the financial reporting process, and indirectly through the oversight of internal control and external audit. Bedard and Gendron (2010) present the following AC framework on AC and dimensions of effectiveness.

**Figure 1: Audit committee framework**



The dimensions of effectiveness ensue from the AC processes. This study seeks to study these processes of the AC.

### 2.2 Composition

Literature indicates the importance of an independent AC that is constituted correctly and includes financial experts (Bronson, Carcello, Hollingsworth & Neal 2009; Gul & Goodwin 2010; Cohen, Hoitash, Krishnamoorthy & Wright 2004). Municipalities are entrusted with public funds through equity share and grants. These public funds are monies collected from the public in the form of taxes. The use of public funds requires accountability. The AC is expected to play an oversight role to monitor the municipalities' use of funds. The AC can perform the oversight role effectively if its composition includes independent members and

financial experts (Blue Ribbon Committee 1999; ASX 2010). The independence and financial expertise will help strengthen the oversight role that the AC plays during the AC process.

There are, however, studies that had different findings in terms of independence versus quality of information. A study by Osma and Noguer (2007) concluded that the presence of an independent AC did not affect the quality of accounting information. This statement was confirmed by Suarez, Garcia, Mendez & Gutierrez (2013); they found that a high proportion of independent members did not lead to significant improvement in quality of accounting information. Pucheta-Martinez and De Fuentes (2007) found that neither the existence nor the composition of the AC had any influence on the tendency to receive qualified opinions in the audit reports.

### 2.3 *Resources and authority*

The complex nature of financial and accounting matters to be reviewed by the AC requires a combination of skills and expertise that are relevant to the public sector. These resources will equip ACs to monitor external and internal controls through training. Skilled AC members will be able to speak to management with authority. Jermias and Gani (2014) found that qualified board members are better management monitors and constitute a more valuable resource for the firms than unqualified board members?. When the AC is effective, it is the organisational and operational behaviour of management that will result in credible information presented before the AC, the implementation of recommendations and thus an improvement in audit outcomes. Research on ACs recognises that a productive relationship between the AC and executive management as well as auditors improves the quality of financial reporting and related governance processes within organisations (Gramling, Maleta, Schneider & Church 2004; Turley & Zaman 2004). Stringent substantial monitoring by the AC should result in the improvement of internal controls which in turn will improve audit outcomes.

The above studies indicate that an AC with independent members and financial experts strengthens its oversight role, however, its composition neither affects quality of information nor influences the audit opinion. ACs can only have a positive impact on audit outcomes when the organisations they serve support their efforts and respond to their advice and recommendations. Van der Nest, Thornhill and De Jager (2008) made recommendations on improving the effectiveness of ACs, focusing on attendance of meetings, recruitment of AC members and recognition of the importance of ACs as an accountability instrument. My study focuses on the AC process. I interviewed all attendees of the AC meeting as part of testing the AC process. The combination of skills in the AC is also addressed. Should the AC fail in providing assurance on the credibility of the reports produced for oversight, decision-making and accountability purposes, vital decisions related to funding, accountability and service delivery will be based on inaccurate, incomplete and unreliable information AGSA (2013).

Deloitte (2006) and King III list the following as characteristics of high-performing ACs: the committee should constitute independent directors; a good mix of expertise (skills and competencies must complement one another); must have a financial expert; knowledge of the

company's business and industry as well as the laws and regulations applicable to the company. Noting the above characteristics and the literature that supports them, there is minimal literature that focuses on AC processes. My study focuses on the AC process to find evidence as to whether the AC does in fact influence the external audit outcomes. A study by Beasley, Carcello, Hermanson and Neal (2009) examines the AC process used by AC members when fulfilling their oversight responsibility with special focus on the tension between the agency theory (Fama & Jensen 1983) versus the institution theory. My study extends the study by Beasley *et al.* (2009) by not interviewing the AC chairman only, but including all other attendees to the AC meeting.

The results of my study will assist the regulators in deciding whether or not they should ensure that municipalities comply with having effective ACs. The regulators will also be able to determine better ways of monitoring ACs to ensure they fulfil their oversight role. The study contributes to the literature that focuses on the AC process in order to identify which aspects affect the AC effectiveness, and the impact on external audit outcomes. This study is expected to give more insight on public sector AC process.

### **3. Research design**

#### *3.1 Case*

In the 2013 financial period, 55 auditees submitted their financial statements for audit (AGSA 2014). The report indicated that nine auditees have improved in audit outcomes. The selection for this study was based on a municipality that had shown improvement in the audit outcomes in the years 2011 to 2013. I made the selection in the Eastern Cape because I was concerned about the poor performance of municipalities in this province compared to the other eight provinces. One municipality was selected for the case study. This municipality (hereafter referred to as Munic) is one of the two that accounted for 42% of the R37.4 billion total expenditure in the Eastern Cape (AGSA 2014). Munic improved from an adverse audit opinion in 2011 to a qualified audit opinion in 2013.

#### *3.2 Method*

The study uses a qualitative research method. As noted by Turley and Zaman (2004), there is a particular need for qualitative research case studies and interviews to understand the complex environment in which ACs operate. The case study approach gathers AC members' insights and allows investigations beyond the formal constitution and official policies, providing room to explore issues that are difficult to examine. The data for the case study was gathered from three sources: (1) semi-structured interviews, (2) annual reports, and (3) any internal documents made available by the municipality. The interviews were organised around six AC process areas adapted from Beasley *et al.* (2009). Management questions were tailor-made from the AC questions to address the expectations and observations from and by management. Several sources of information were used to design the questions, including: (1) academic literature (e.g. Beasley *et al.* 2009; Turley & Zaman 2007); (2) the professional literature (e.g. King III), and (3) the researcher's prior experience working with ACs, internal auditors and external auditors.

The following people were interviewed:

**Table 1: Interviews with relevant personnel**

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1. Audit Committee Chair
  2. Four audit committee members
  3. Chief Financial Officer
  4. Acting Chief Operating Officer
  5. Acting Director: Corporate Services
  6. Acting Internal Audit Manager
  7. Former Internal Audit Manager
  8. Acting Director: Health and Public Safety
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**Table 2: Attendees to AC meetings**

<b>Portfolio</b>	<b>Number attending audit committee meetings</b>	<b>Number interviewed</b>
Audit committee members	6	5
City Manager	1	0
CFO	1	1
Directors	7	4
Compliance Manager	1	0
Municipal Public Accounts Committee chairperson	1	0
Internal audit	1	1
External audit	2	0

The interviews were recorded and interviewees were assured of confidentiality of information and anonymity. The AC members that were interviewed had different periods of experience within the AC of the municipality: three members had been with the municipality for three years and the other two for just less than a year. The directors and managers ranged from being in their current positions with the municipality for a period of one year and three months to twenty years. Although some are referred to as *acting*, they had been in these positions for a long time.

#### **4. Limitations to the study**

Limited participant availability made it necessary to restrict interviews to key management. Nevertheless, similar views were expressed by the interviewed managers, suggesting only a small chance that new significant information would have been discovered had the researcher interviewed all managers.

## 5. Findings and analysis

**Table 3: Interview questions**

<b>A</b>	<b>Acceptance and continuance of due diligence processes</b>
1	What steps do AC members take before agreeing to join the AC and agreeing to remain on the committee?
2	Why would a member decline to serve on the AC or leave an existing AC?
<b>B</b>	<b>Selection of AC nominees</b>
3	How are members identified to serve on the AC and why are they asked to join the committee? Who appoints the AC members?
<b>C</b>	<b>AC meeting processes</b>
4	How often do ACs meet, for how long, and which groups are included in the meeting? Management (M): Do you think the composition of the AC and the frequency of meetings assist the AC in fulfilling its oversight mandate?
5	How, when and by whom are the agendas for AC meetings prepared? M: Do you have any contribution to the agenda? How do you know if you have to make a presentation in the AC meeting?
6	Who determines the information included in the information pack received before committee meetings, when is the information pack received, what information is included in the pack, how do AC members review the information, and what are they examining for as they review the information? M: Do you think AC members present themselves as having reviewed the information?
7	What types of information do AC members receive between meetings, from whom is this information received, and how often is information received? M: Is there any information that you receive in-between meetings?
<b>D</b>	<b>AC oversight of the financial reporting process</b>
8	What financial risk areas are reviewed by the AC?
9	What is the nature of the AC's involvement in reviewing the municipality's accounting policies and accounting estimates/judgements/assumptions? M: To what extent is the AC reviewing the financial information?
10	How does the AC assess the risk of fraudulent financial reporting, including how it assesses management's integrity and interacts with the internal and external auditors in making this assessment?
11	What is the nature of the AC's involvement in reviewing alternative accounting treatments available under Generally Recognised Accounting Practice (GRAP)?
<b>E</b>	<b>Oversight of the internal and external audit processes</b>
12	What is the nature of the AC's interaction with internal audit (hiring and firing authority; setting budgets and scope of work, reporting relationships, and meeting frequency and type)? Internal Audit (IA): Do the AC discussions impact the following: Audit risk assessment, IA plan, resolution of contentious issues, and the type of audit report?
13	What is the nature of meetings and other communications between the AC and the external auditor?
14	What types of purchases of non-audit services are approved by the AC, what factors are considered by the committee before approving the purchase of non-audit services that the AC would not purchase?
15	How does the AC know about the risk areas identified by the external auditors?

<b>F</b>	<b>Other AC activities</b>
16	How, and to what extent, does the AC benchmark its practices against "best practices"?
17	How, and to what extent, is the AC involved in reviewing the municipality's code of conduct?
18	On an overall basis, how comfortable is the AC that it understands the municipality's key financial reporting risks? M: How comfortable are you that the AC understands the municipality's key financial reporting risks?
19	How do AC members evaluate the strength of internal controls? Internal Audit: Does the AC play a role in respect of internal controls?
20	What do AC members view as their most important task in fulfilling their responsibilities? M: What do you view as the most important task for you as manager in enabling the AC to fulfil their oversight mandate?
21	What do AC members view as the most important personal attribute/ characteristic needed to be an effective AC member? M: What do you view as the most important personal attribute/characteristic to be an effective AC member?
<b>G</b>	<b>Conclusion (Management)</b>
22	How effective is your AC in turning things around?
23	Do you believe that the AC had an impact on external audit outcomes?
24	Who do you think has a significant impact between the leadership tone (City Manager) and the AC?

### 5.1 *Acceptance and continuance of due diligence processes*

This study found that members performed due diligence before accepting the AC position. The members focused on the risk profile of the municipality and challenges based on the management and audit report. The AC members assessed the reputation of the municipality through consultation with management and people they regarded as relevant. Members indicated that they would leave the municipality's AC if they thought they were not adding value and if their recommendations were not taken seriously. It appeared that the AC members accepted the position with a view of engaging in monitoring management rather than for compliance purposes.

### 5.2 *Selection of AC committee nominees*

The interest in the selection process was due to examining if the members were appointed because they were friends with management and would therefore not question management and management would not open up to the AC, keep issues to themselves and not make management account (Spira 2002). With Munic, appointment of AC members is done by the Council. Management advertises the vacant AC positions and on responding positively, CVs are scrutinised based on the required skill. No member indicated that he/she was friends with management; however, there was a member that had a spouse working at the municipality. The AC makes a recommendation on the kind of skill that is required based on the current composition of the AC. The committee currently has members with a number of different skills including the following: a financial expert that is a chartered accountant; a former senior manager with significant experience in the Office of the AGSA; a legal person; a member with significant municipal experience; a performance management expert and an academic.



The existing AC started with three members as per the charter. Due to the magnitude of work, the committee was increased to six members. Pucheta-Martinez and De Fuentes (2007) found that the AC size and the independence have a significant influence on the likelihood of receiving a qualified audit report.

Management expressed some satisfaction based on their observation of the composition of the AC, but indicated that it can sometimes be challenging to have members that do not understand the complex environment that the municipality operates in. The AC members appeared to take the monitoring role seriously as they considered the composition of the committee thoroughly.

### 5.3 *AC meeting processes*

An agenda and minutes give structure to proceedings and provide a formal recording of the meeting process. The agenda of each meeting constrains the consideration of specific issues within a particular time frame. A very crowded agenda may impose pressure on the committee which in turn limits full debate and this might be to the advantage of those that want to hide information (Spira 2002). If management prepares the agenda they can manipulate it or control it by talking to the chairperson beforehand. In Munic, the agenda and minutes are prepared by internal audit unit in consultation with the AC chairperson. AC meetings have consistently been found to be associated with higher financial reporting quality (Turley & Zaman 2004). The AC meetings were initially held once every quarter. The magnitude of challenges due to significant weaknesses in controls and the high risks that were identified by internal auditors and external auditors resulted in meetings being held monthly. This helped to prevent the overloading of the agenda and allowed more engagement with management and internal auditors. The meetings were formal and are attended by AC members, internal audit unit that also act as secretariat, external auditors, MPAC chair and the top management. The year planner for meetings is drafted by the chairperson based on legislative requirements. The agenda is prepared by the internal audit unit based on the planner and in consultation with the AC chair. The agenda determines what must be in the AC pack. The pack is sent to members seven days before the meeting, but sometimes the members receive the pack five days before the meeting. It was clear from the responses that even though the meetings are held monthly, members have sufficient time to review the pack. All interviewees confirm that they review the pack before the meeting.

The meeting runs for a maximum of five hours. Some members indicated that if they have a tight schedule they will skim through the minutes, read the agenda, and prioritize certain items that are critical. It appears that members attempt to engage with the pack rigorously and meaningfully. Although management is happy with the AC meeting process, there are some concerns. Some management members feel that sometimes the AC goes beyond its oversight role and becomes operational. Management is happy with the frequency of meetings as they believe the influence of AC will improve the control environment. Management attested to the AC reading the pack, and emphasised the importance of the kind of questions the AC asks. These responses point to substantive activities by the AC.



#### *5.4 AC oversight of the financial reporting process*

The internal audit plan is risk-based. The AC reviews all the financial reporting risks and mitigation plans. They formulate areas of focus from the qualification opinion, repeat findings, Supply Chain (SCM) and Human Resources (HR). The AC works on the basis of the AC charter. Significant funds go through SCM and revenue department, therefore AC focus will be on such areas. The AC examines all financial risks in the two meetings before the submission of annual financial statements. Financial statements are thoroughly reviewed only at year-end as monthly accounts are normally incomplete. The financial statements are reviewed thoroughly by internal audit followed by a high-level review by the AC. Internal audit is required to review disclosures, accounting policies and financial statements. There has been significant improvement in the quality of annual financial statements (AFS) at Munic. The AC has a plan with milestones that addresses all the findings and actions to address the findings. Internal audit validates if findings have been addressed. Munic's risk assessment is done annually. The AC participates in the process. The risk committee reports on a quarterly basis at the AC meetings. There is an agenda section for new risks. Prior research suggests that ACs can improve financial reporting quality by reducing the incidence of fraudulent reporting and accounting irregularities (Rainsbury, Bradbury & Cahan 2009). Fraud is a standing item on the agenda of all AC meetings.

It appears that the AC monitors the financial reporting process. There was, however, no indication of serious involvement in the analysis of judgements. Some members could not specifically identify the key financial reporting risk, and this could indicate a challenge in effective monitoring of the financial reporting process.

#### *5.5 Oversight of the internal and external audit process*

##### *Audit committee interactions with external audit*

The AC holds separate meetings with the AGSA. There were more of these meetings especially before and during the audit process. The meetings with external auditors also discussed the risks identified by the external auditors, including the risk of fraudulent financial reporting.

##### *Audit committee interactions with internal audit*

Regular meetings between the AC and the internal auditing department make it likely that the AC remained informed and knowledgeable about relevant accounting and auditing issues (Sarens, De Beelde & Everaert 2009). Munic's AC holds separate meetings with internal audit. Internal audit (IA) of Munic is co-sourced. The internal audit plan is approved by the AC. The study by Soh and Martinov-Bennie (2011) found that a full or partial in-house IA is, due to increased visibility and profile, more effective than one that is completely outsourced. There appears to be a strong relationship between the AC and internal audit. A close working relationship between internal audit and the AC is recognised as a fundamental principle of sound corporate governance (ASX, 2010).

### 5.6 *Other AC activities*

The members benchmarked themselves against the King III and other municipalities. The strength of internal controls is evaluated based on internal audit reports and the dashboard report on key controls that is supplied by AGSA. The AC views getting a clean audit report as the most important task in fulfilling their responsibilities. Management believe their main task is to ensure they report and submit quality reports with adequate information.

### 5.7 *Effectiveness of the AC in turning things around*

Management believe the AC is performing its oversight role. Their belief is based from the audit reports Munic received from AGSA which indicated improvements in internal controls. Management see a gradual turn in management attitude towards controls resulting in the improvement of the control environment.

### 5.8 *Influence of the AC on external audit outcomes*

Management believe the AC has a positive influence AC on external audit outcomes.

### 5.9 *Influence of AC versus leadership (administration – City Manager)*

Leadership tone appeared to have a greater influence than the AC on change in the control environment which then leads to changes in audit outcomes AC. There is consensus that the AC does influence external audit outcomes, but it has a smaller influence than leadership tone. The administration leader is very hands-on in the audit process and that affects the external audit outcomes. At a rating of 100%, management indicated that when looking at the parties that influence external audit outcome, leadership tone will be 60% and AC 40%.

### 5.10 *Weaknesses identified by management on AC process*

Management feel that the AC is not firm in their recommendations to Munic executive as a committee of Council like they do with management. Use of inexperienced trainees by auditors is problematic as the municipality is a very complex environment. The understanding of the municipality is very important to auditors in properly performing their jobs. The results demonstrate the importance of the AC process in fulfilling the oversight role. Beasley *et al.* (2009) found that members of the AC strive to provide effective monitoring of financial reporting and seek to avoid serving on ceremonial ACs. However, in six AC process areas they found evidence of both substantive monitoring and ceremonial action, such that neither agency theory nor institutional theory fully explains the results (Beasley *et al.* 2009). This study concurs with the finding of Beasley *et al.* (2009) that the AC strives to provide effective monitoring of financial reporting. The effective monitoring results in an improvement in internal controls which translates to improvement in external audit outcomes. This finding indicates that the AC strives to provide effective monitoring because of the challenges that have been identified from the interviews. The challenges that the AC appears to be facing include: (1) understanding the municipal environment fully due to its complexity, and (2) clear articulation of the key financial reporting risks. Management concur that decisions that are made by council should be based on credible financial information; however, they think the AC was not as firm with the executive as they were with the administration.

**Table 4: Summary of substantive versus ceremonial activities**

<b>Activities</b>	<b><i>Substantive</i></b>	<b><i>Ceremonial</i></b>
Due diligence process	100% extensive due diligence process done before joining the AC,	
Selection of AC	Approval and appointments made by council. Management have some involvement; however, no member was friends with management.	
	Members chosen based on expertise.	One member indicated that he was encouraged to apply for the position.
Resignation	50% indicated that they would resign if their recommendations were not taken seriously, and 50% if the admin was in shambles and there was unethical behaviour from admin.	
Composition (Financial expertise and independence)	50% of all AC members have financial expertise including a chartered accountant. 100% of AC members are independent.	
Agenda and minutes	Prepared by internal audit in consultation with the AC chairperson.	
Review of information pack	Pack received 5-7 days before the meeting. 60% review thoroughly all the time.	40% of AC members do a superficial review if they are pressed for time.
		Three managers and one AC member concerned with the types of questions asked by AC members.
Financial reporting process. Financial reporting risks	Two AC members spelt out the financial risks. Thorough review of AFS by internal audit that is co-sourced before being presented to management.	Though the AC reviews financial risks, other members were vague in their response — including on whether they review accounting policies and judgements. They did not spell out the specific financial reporting risk areas.
Review of accounting policies, estimates and judgements.	Involved in accounting policy through the review of AFS.	Minimal AC involvement in accounting policy choice.
Fraud risk of financial reporting	Management made to account on fraud at every meeting. Reliance on auditors for assessment of fraud risk.	
Oversight of internal and external auditors	There is extensive formal and informal contact with internal and external auditors.	AC does not approve the budget of the internal audit.
Other committee activities	AC benchmark themselves against best practise.	
Comfortable in knowing the municipality's key financial reporting risks	60% of members are comfortable.	40% not comfortable.

**Note:**

The percentages in this table are based on the number of members that were interviewed unless otherwise stated.

**5. Discussion**

The study makes three main contributions to the academic literature. Firstly, the study extends previous research, in some cases it confirms findings of the previous research on AC process (Gendron, Bedard & Maurice 2004; Beasley *et al.* 2009; Cohen, Krishnamorthy & Wright 2010; Spira 2002). This study examines the AC process in the public sector in South Africa with specific reference to the municipality, while the other studies focused on the private sector in The United States, Canada and The United Kingdom. Secondly, the researcher provides insights on what happens in the AC meetings of the municipalities. This study uses one case study to explain and explore the AC process with the views obtained from the different parties in the AC. The other studies used three corporations (Gendron *et al.* 2004), 42 AC chairpersons from different U.S. public companies (Beasley *et al.* 2009), and 30 audit managers and partners from three of the four big firms (Cohen *et al.* 2010). Thirdly, from a theoretical perspective, while AC members and management have appeared committed to substantive monitoring of financial reporting, the interviews revealed a mix of substantive and ceremonial activities with more weight on substantive activities. This agrees with the finding of Beasley *et al.* (2009). Additional theoretical work should further examine the role of the AC, possibly by increasing the sample of municipalities.

The results can be viewed in the context of the AC framework on AC and dimensions of effectiveness, according to Bedard and Gendron (2010) (see Figure 1). Academic literature states that for an AC to be effective, it should be independent and have the right composition which includes financial experts (Bronson *et al.* 2009; Gul & Goodwin 2010; Cohen *et al.* 2004). The findings from interviews confirmed this as the members believed it was important to have different skills, financial experts and independent members in a committee. Resources and authority assist in stringent substantial monitoring by the AC which should result in the improvement of internal controls. The study revealed that a productive relationship between the AC and executive management as well as auditors improved the quality of financial reporting and related governance processes within the municipality. This concurred with the findings of Gramling *et al.* (2004) and Turley and Zaman (2004). Jermias and Gani (2014) found that qualified board members are better management monitors and constitute a more valuable resource for the firms. The AC of Munic has qualified members.

The thorough review of the pack ensures that the process of preparing for the AC meeting is constructive and allows the AC members to contribute meaningfully to the meeting and that the municipality benefits from it. The analysis of this case study shows that ACs have significant influence on power relations between municipality participants. The existence and operation of the AC has pervasive behavioural effects. The interrogation of the reports to be tabled by management in the AC meeting could be as a result of the AC members having thoroughly read the pack. The increase in the frequency of meetings and the number of AC

members shows the important role that is to be played by the AC to enhance quality of reporting. An effective AC enhances quality of accounting reporting (Al-Ajmi 2009).

The findings by Gendron *et al.* (2004) indicated that members place emphasis on financial statement accuracy, financial report wording, control effectiveness and audit quality. The findings of my study indicate that members put more reliance on internal audit for thorough review of financial statements, accounting policy choice and accounting judgements and estimates. This could create a weakness in the AC process. This control weakness could, however, be mitigated by the oversight of the internal audit. The municipalities are more complex in terms of operations and financial reporting. This creates a problem in terms of the AC fulfilling its oversight role as the questions they ask do not always reflect a sound understanding of the municipality. AC members who do not ask questions will cause management to try keeping things to themselves, sweeping them under the carpet rather than explaining an issue (Spira 2002). This weakness could represent rubber stamping. A matter of interest is the fact that management think that the AC is gradually turning things around in the municipality in line with the general response that things are being turned around.

The AC requested management to prepare an audit improvement plan in 2013 financial year. This plan was based on the external audit findings of 2012. Management had to report regularly on the progress in addressing the findings in the plan. This process contributed towards reducing the number of audit findings. The study therefore recommends that the AGSA should continue reporting on the effectiveness of the AC as that puts pressure on the AC to perform. There are a number of limitations that must be borne in mind when interpreting these findings. The sample size is small as the case study was done on one municipality and the findings cannot be generalised. In spite of these limitations, the results have important implications for regulators and others concerned with the role of ACs in corporate governance. Further research should be done on municipalities that do not have functional ACs, but that have improved in external audit outcomes. It would be interesting to include the external auditors in the interviews to test whether the AC process does improve internal controls that will result in the improvement of external audit outcomes.

## **6. Conclusion**

This study examines the influence of an AC on external audit outcomes. The study finds that the AC influences the external audit outcomes. Members of the AC strive to provide effective monitoring of financial reporting rather than being ceremonial. The AC members appeared to view independence of AC members, composition of the AC, a variety of skills, attendance at meetings and being fully prepared, and enhancement of good quality reporting by management as key to what they regard as the most important task of the AC in attaining a clean audit report. The following recommendations should assist in improving the effectiveness of ACs in municipalities: (1) It should be compulsory that the accounting officer, management, internal audit and all AC members attend AC meetings. (2) Whilst members with financial expertise are appointed to an AC, there is a need for government to regulate serious training of the AC members in the municipality environment. The municipal environment is complex and for effective monitoring to occur there should be thorough

understanding of the municipality. (3) The AGSA should continue reporting on the effectiveness of the AC to put pressure on the performance of the AC. (4) The frequency of meetings should depend on the control environment of the municipality. Meetings were changed from quarterly meetings to monthly meetings as there was a turn-around plan within the municipality. (5) Government must ensure that all municipalities appoint ACs. It appeared that improvements were due to a combination of different factors including the leadership tone and effective AC. Management believes that leadership tone has a greater influence on external audit outcomes than an AC at a rate of 60% to 40% respectively. However, the AC can only have a positive impact on audit outcomes when the municipality they serve supports their efforts and responds to their advice and recommendations.

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