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DRIVERS OF AUDIT QUALITY IN SOUTH AFRICAN PUBLIC SECTOR

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ABSTRACT

This paper examined the relationship between leadership, financial management, risk management, governance and clean audit. The independent variables (leadership, financial management, risk management and governance) were extracted from the Auditor General's reports on audit outcomes for municipalities in South Africa for the five years from 2009/10 – 2013/4, and used to determine the degree to which they are related to the achievement of clean audit outcomes. A quantitative approach (panel data regression analysis) was employed, based on a positivist paradigm, to examine the relative effects of the independent variables as key to achieving clean audit outcomes. The findings show that leadership, financial management, risk management and governance jointly have a significant relationship with clean audit outcomes, with a value of $P < 0,005$ (which is substantially below the 5% Alpha level anticipated at the start of the research for this paper) and additionally point to the existence of a much more significant relationship between achieving a clean audit outcome and governance. The paper contributes to theory and practice. The theoretical contribution is that the independent variables (leadership, financial management, risk management,

governance) need to work jointly to deliver an effective accountability and quality audit – hence further research should examine such influence jointly and also try to add additional independent variables. The practical implication is that public sector governance may not be blamed as a single factor that causes accountability or audit issues.

Key words: *financial management; Audit quality; leadership; governance; risk management; clean audit outcomes*

1. INTRODUCTION

In recent years the topic of audit quality has been researched and correlated with various factors and influences. Of course, in the prevailing global economic environment the topic of audit quality continues to generate intense interest both in the auditing profession and amongst audit clients and their stakeholders. Although the International Federation of Accountants (IFAC) continues to discuss audit quality at great length, and has produced many major reports (IFAC, 2014). A common element of discussions on audit quality is to remind all parties involved about the importance of maintaining focus on improving audit quality, and particularly in the public sector (Portal, 2011; Deis Jr & Giroux, 1992). This paper, then, mainly focuses on whether audit quality leads to clean audit outcomes, or vice versa, and whether the term 'audit quality' is interchangeable with 'audit outcome', or if the two terms compliment each other. In fact, the interrelationship between the two terms is essentially obvious, and the trend of research on audit quality and the achievement of clean audit outcomes is summed up in Francis' (2004) study that deals with 'what do we know about audit quality'; the findings indicate that audit outcomes are informative and necessary to motivate an entity to achieve an optimal level of audit quality.

The importance of understanding audit quality in the public sector is that it reflects the quality of the entity's leadership, financial management and governance (AGSA, 2011/12). According to Kilgore, Harrison and Radich (2014), the issues of audit quality are among the most studied and talked about in the auditing profession. These illustrate that it is important to understand that audit quality is an ongoing process of accumulating improvements (Francis, 2004) and can be observed and measured in terms of the audit outcomes. Of course, one of the most dramatic changes in South African public sector auditing since 2009/10 is the emergence of the phrase "clean audit outcome" as a motivating objective. Since then, public sector institutions have adopted the position that audit quality is about reaching the right audit opinion.

While the audit profession continues to search for a uniform definition of audit quality, to enhance the quality of audit opinions, the concept of audit qual-

ity has been widely accepted as a function of the quality of internal controls (AGSA, 2011/12). While audit quality is a global professional issue, in the South African public sector the AGSA has returned to the view that *any* matters that contribute to the achievement of clean audit outcomes need to be examined and optimised. Thus, the AGSA has identified the three key drivers of internal control as leadership, financial management and governance. The improvement of an audit outcome therefore depends on achieving improvements in the effectiveness of these key drivers of internal control. Thus, as leadership, financial management and governance are widely recognised as key business elements possessing the ability to influence the achievement of an improved audit quality (AGSA, 2013; Webb, 2015; Francis, 2004, Jelic, 2012; Otley & Pierce, 1995; Krohmer & Noël, 2010; KPMG, 2014b; Rahimi & Amini, 2015; Neri & Russo, 2014; IFAC, 2014; Ziaee, 2014; Darabi, et al., 2012; Alrsha, 2015; Gajevszky, 2014; Fooladi & Farhadi, 2011; Adeyemi & Fagbemi, 2010; Khlif & Samaha, 2014), and as South African municipalities routinely fail to achieve clean audits, it was recognised that there was a need to research the present effectiveness of leadership, financial management and governance in South African municipalities.

This investigation is thus important as it examined the links between the three key drivers of improved audit quality identified by the AGSA (2013) (leadership, financial management and governance,) and the fact that the vast majority of South African municipalities failed to achieve clean audits by the 2014 target. An examination therefore seemed appropriate to determine how effective these drivers have really been in the public sector's journey to achieve clean audits.

2. LITERATURE REVIEW

2.1. AUDIT QUALITY:

The term audit quality encompasses the key elements within the financial reporting chain (such as inputs, processes, outputs and key interactions), which enhances a consistent performance of quality audit (IFAC, 2014). The audit function is said to have quality if the auditor exercises diligence in discovering and reporting obvious errors in the accounts of a client under audit (DeAngelo, 1981). Outputs collectively comprise one of the elements by which audit quality is evaluated, and include (internal) auditors' reports (to users, governance, management and regulators); reports of the audit committee; information provided by regulators on individual audits; transparency reports; annual reports, and the results of the audit firm's inspections (IFAC, 2014). Therefore, for the purpose of this study, the term 'audit quality' is used as

a catch-all phrase signifying the sum of the elements of an audit outcome. An audit outcome is also an element (or function) of audit quality (IFAC, 2014) and is a communication from the auditor – usually in the form of a written opinion (Fahami, et al. 2016) - to statutory, regulatory, institutional and interested and affected parties and clients of the entity. It is the last product or service in the accounting process and is rendered by the auditor.

2.2. LEADERSHIP AND AUDIT QUALITY

Recently published research has linked audit quality and leadership (Webb, 2015; Francis, 2004; Jelic, 2012; Otley & Pierce, 1995; Krohmer & Noël, 2010; Rahimi & Amini, 2015). These researchers show that audit quality is higher when leadership independently executes its responsibilities. Francis (2004) supports this observation when he makes a call for leadership not to interfere with the administration and audit activities. Thus, the implication is that leadership is to be blamed for poor audit quality. Otley and Pierce (1995) examined how subordinates' reactions to control systems is influenced by the behaviours of supervisors (their immediate leaders). Their findings indicate that a leadership style characterised by a rigid and highly structured control approach, and a low consideration of the individuals' input and efforts, is strongly associated with increased levels of dysfunctional behaviours – both amongst workers and in the leadership complement of the entity. These behaviours have a negative impact on audit quality. Therefore, the importance of good leadership is fairly obvious; good leadership is thus desperately needed to address the challenges of audit quality (which records and reflects the state of basic service delivery in the South African local government environment.) Leadership style can have a major influence on the performance of the organisation and the associated audit outcome. This view is supported by Krohmer and Noël (2010): they investigated both personal and professional ethics as key elements of responsible leadership within the Big Four audit firms in France. Interestingly, their findings revealed that personal ethics are mainly associated with ethical organisational structures, and that they also essentially guarantee enhanced audit quality. They further identified that leading by good example is a favoured way to improve audit outcomes and audit quality (Krohmer & Noël, 2010). Jelic's (2012) research confirmed that the personal ethical skills of a leadership team remains the strongest influence in improving audit quality.

2.3. FINANCIAL MANAGEMENT AND AUDIT QUALITY

While a review of recent academic literature discovered no direct association between financial management and audit quality, because the AGSA has identified financial management as one of the three key audit quality drivers it was deemed appropriate to discuss the main elements of financial management and audit quality. These elements are the quality of financial reporting, and the quality of financial internal controls. Prior research has identified several measures that have a greater or lesser influence on audit quality: these include the audit fee, size of audit team, auditors' independence, auditor tenure, professional scepticism and many more (IFAC, 2014; Rahimi & Amini, 2015; Neri & Russo, 2014; Svanberg & Ohman, 2013).

Likewise, the output (audit opinion), audit process (auditors' understanding of the audit environment) and input (auditor's perception) are all components and measurements of audit quality (IFAC, 2014). With all these processes being successfully completed, Rahimi and Amini (2015:101) explain, the 'audit quality' becomes the sum of the quality of the audit and the audit process. The quality of audit is thus about the checklist – by the diligence devoted to checking compliance with the applicable standards (Neri & Russo, 2014). Therefore, on successful completion of an audit, financial management's offer of solutions for investment decisions, financing decisions and dividend decisions is all the more compelling (Ciuhureanu, et al., 2009). Although no studies were found that established a direct relationship between financial management and audit quality, it appears valuable to consider the relationship between financial reporting and internal financial controls, as a part of financial management. Therefore, audit quality plays an important role determining the reliability of financial statements (Alrshah, 2015). Again, audit quality as an outcome depends on the quality of the input – and that depends on the effectiveness of financial management's positive influences.

Since financial management involves the use of a variety of tools to manage the finances of an organisation, Chen, et al., (2013) used quality audit, size of audit firms and financial performance of audit firms to determine these tools' relationship with audit quality. They concluded that there are positive relationships and that audit quality does improve financial performance. According to Furouk and Hassan (2014:2), the effect of audit quality on financial management and performance is realised when an independent audit, through its rigour and coherent reporting, improves confidence in the entity's financial reporting. Thus, the results of the study by Farouk and Hassan (2014) confirm that a positive relationship exists between audit quality and financial performance, and that a quality audit outcome positively affirms the quality of a firm's ability to be profitable.

2.4. GOVERNANCE AND AUDIT QUALITY

The relationship between governance and audit quality is that effective governance adds significantly to the quality of the audit outcome. Governance, because it is multi-faceted (multidimensional), influences audit quality in a variety of ways (Alrshah, 2015; Lin & Hwang, 2010; Enofe, et al., 2013; Adeyemi & Fagbemi, 2010; Bills & Cunningham, 2015; Christensen, et al., 2013). There are direct and indirect links between the governance functions and audit outcomes and/or audit quality. Direct links and relationships have been investigated in numerous studies of the relationship between governance and audit quality (Gajevszky, 2014; Fooladi & Farhadi, 2011; Alrshah, 2015). These studies have confirmed that good governance plays an important role in enhancing audit quality. However, a small minority of studies (Deumes, et al., 2012; Beisland, et al., 2015) have found a negative association to exist between audit quality and governance. These researchers found that the dominant positive influence on audit outcomes depended on the quality of financial controls. In fact, despite the fact that good governance is a great contributor to ensuring internal control quality (Li, 2015; Yeoh & Jubb, 2001; Lin, et al., 2014), the auditors themselves put more reliance on the quality and effectiveness of specific internal controls than they did on the rest of the governance aspects, as their experience suggested that these controls are key to realistic financial reporting, which is fundamental to determining the quality of the audit report (Khlif & Samaha, 2014).

3. METHODOLOGY

Data: The data set for the research discussed in this article comprised the Auditor General South Africa's annual reports for all municipalities in the nine provinces of the Republic of South Africa for the financial periods 2009/10 – 2013/14. The data set was analysed from the perspective of the key drivers of a clean audit outcome - leadership, financial management, governance and risk management. Regression analysis was used as an appropriate technique to enable the determination of the dependent variable, and also to provide a better assessment of the relationships the dependent variable has with each independent variable.

The primary purpose of this paper is to examine the relationship that might exist between the key drivers of internal control and clean audit outcomes. The study focused exclusively on the AGSA's reports on the audit outcomes for the selected five financial years. Thus, this does place a limitation on the research as it ignores all the previous and subsequent AGSA and other reports. The data collected from the AGSA's annual assessments of audit outcomes were

assessed and the key drivers of internal control were scored/ranked: these include leadership scores, financial management scores, governance scores and risk management. These key scores were then used to evaluate the effects of the key drivers of internal control on the audit outcomes.

In this paper, the research relied on secondary data, collected from AGSA audit reports. As the data was available in the AGSA's consolidated annual reports on local governments, the data included the research variables for each/all municipalities: the degree to which a clean audit outcome had been achieved, and leadership, financial management, and governance. This paper then focuses on the multiple regression tests performed on this data. The first predictor was leadership (shortened to **Led**); the second predictor was financial management (shortened to **FinMgt**), the third predictor was governance (shortened to **Gov**) and the fourth predictor risk management (shortened to **RiskMgt**). The predictor value (achievement of a clean audit,) was shortened to **CLAud**).

Although the AGSA highlights all areas that are seen to be contributing to weak audit outcomes, this paper focused on four specific variables, and the four multiple regression tests that were conducted to examine the relationships between leadership, financial management, risk management and governance, and clean audit outcomes. The paper makes use of these outcomes to formulate recommendations on how audit quality could be improved for these entities.

Data analysis technique: The data was subjected to quantitative and correlation analysis to measure the relative strengths of the relationships between clean audit outcomes and each of the three independent variables. The statistical analysis employed a multiple regression model, and the general formula (according to Babbie & Mouton (2010:464)) is:

4. RESULTS AND DISCUSSION

Since there are three independent variables (leadership, financial management and governance) that the AGSA regards as predictors of the achievement of 'clean audits', these variables were treated as the independent variables when analysing the data to examine the relationship between them and the achievement of a clean audit outcome. In the analysis of each of the four variables, clean audit (**CLAud**) is the dependent or predicted variable. Accordingly, the three variables were tested jointly in the panel data multiple regression tests and the results presented in Tables 1 and 2 below. The findings and discussion are presented by variables identified as able to bring about clean audit outcomes. These factors or drivers of clean audit outcomes are "... leadership, financial management, risk management and governance" (AGSA, 2014:1).

Table 1 Regression result of four independent variables and clean audit

Fixed-effects, using 45 observations
 9 cross-section units
 Length of Time-series = 5
 Dependent variable: CLAud

	<i>Reg Coefficient</i>	<i>Stand. Error</i>	<i>t-ratio</i>	<i>p-value</i>	
const	0.00821362	0.0402834	0.2039	0.83973	
RiskMgt	-0.0376614	0.130096	-0.2895	0.77407	
Led	-0.316656	0.21553	-1.4692	0.15154	
FiNMgt	0.0991442	0.239279	0.4143	0.68139	
Gov	0.393969	0.185142	2.1279	0.04114	**
Mean of dependent variable			0.052667		
Squared residual sum			0.121107		
R-squared			0.533990		
(F) P-value			0.005743		
F(12, 32)			3.055669		

It is important to also check if the governance variable could function effectively as a core driver of clean audit in the absence of other variables. We proceeded to check this by allowing governance to function as a single independent variable in Table 2.

Table 2 Regression result of Governance as a single variable and clean audit

Fixed-effects, using 45 observations
 Included 9 cross-sectional units
 Time-series length = 5
 Dependent variable: CLAud

	<i>Coefficient</i>	<i>Std. Error</i>	<i>t-ratio</i>	<i>p-value</i>
const	-0.00696663	0.0386198	-0.1804	0.85789
Gov	0.216063	0.135936	1.5894	0.12095
Mean dependent variable			0.052667	
Sum squared residual			0.132067	
R-squared			0.491814	
(F) P-value			0.002144	
F(9, 35)			3.763606	

The regression result in Table 1 show that a combination of the four independent variables - leadership, financial management, risk management

and governance are jointly significant at $P=0.005$. It is important to note two important findings from this analysis; one is that the significance result of a P value of 0.005, shows that it is only the combined effect of leadership, financial management, risk management and governance which made the relationship to be highly significant in their influence on the achievement of clean audits. Looking at the individual independent variables in Table 1, it can be seen that governance exerts the most significant influence on clean audit with a p value of 0.04, which brings up the second important finding, which is that governance alone is not able to deliver strong influence on clean audit without the support of other variables. In order to expatiate this, we then tested the single effect of governance on clean audit in Table 2, which proved insignificant as a stand alone variable. The practical and theoretical implication is that public sector governance may not be blamed as a single factor that causes accountability or audit issues.

5. CONCLUSION

The present paper set out to examine the relationship between the achievement of a clean audit outcome and the aspects of leadership, financial management, risk management and governance within South African municipalities. The objective of this paper was to examine the relationship between each independent variable and audit quality - thus the relationship between audit quality and leadership; audit quality and financial management; audit quality and risk management and audit quality and governance. The data was collected from the AGSA's annual reports on audit outcomes for municipalities in South Africa for the five financial years between 2009/10 and 2013/14. A quantitative research approach was employed, enabling the use of a regression model to analyse the data (the research design is positivist and measures specific variables). Thus, the panel data regression identifying the determinants of clean audits showed that the P -value is less than 5%: this leads to the conclusion that the independent variables tested do show the existence of a relationship between the achievement of a clean audit (audit quality) and governance. This relationship is jointly statistically significant at a $P=0.005$ level, when tested on the fixed effects. This recognition of the combined effect of the key drivers on audit outcomes in the South African public sector auditing environment is important in that it enables ongoing efforts to improve audit outcomes to become more effectively focused. The research made two important contributions and recommendations for theory and practice. The theoretical impact is that the variables cannot produce a quality audit as single variables, they need to work jointly to deliver an effective accountability and hence quality audit – hence further research should examine such influence jointly and

also try to add additional independent variables. The practical implication is that public sector governance may not be blamed as a single factor that causes accountability or audit issues. Therefore, when studying governance and public service delivery, future researchers should try to isolate governance after joint analysis to check if governance might produce a significant result in extended number of years of observation.

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POKRETAČI KVALITETE REVIZIJE U JAVNOM SEKTORU JUŽNE AFRIKE

SAŽETAK RADA:

U radu se ispituje odnos vodstva, financijskog menadžmenta, upravljanja rizicima, upravljanja i čiste revizije. Nezavisne varijable (vodstvo, financijski menadžment, upravljanje rizicima i upravljanje) izdvojene su iz izvješća glavnog revizora o rezultatima revizije za općine Južne Afrike za pet godina od 2009./10. do 2013./14. a korištene su za određivanje do kojeg se stupnja oni odnose na postizanje čistih ishoda revizije. Kvalitativni pristup (regresijska analiza panel podataka) korišten je na temelju pozitivističke paradigme, kako bi se ispitali relativni učinci nezavisnih varijabli kao ključ za postizanje čistih ishoda revizije. Rezultati pokazuju da vodstvo, financijski menadžment, upravljanje rizicima i upravljanje imaju zajednički značajni odnos s čistim revizijskim ishodima, s vrijednošću $P < 0,005$ (što je znatno ispod razine od 5% očekivanog na početku istraživanja za ovaj rad) te dodatno ukazuju na postojanje mnogo značajnijeg odnosa između postizanja čistog ishoda revizije i upravljanja. Rad pridonosi teoriji i praksi. Teorijski doprinos je da nezavisne varijable (vodstvo, financijski menadžment, upravljanje rizicima, upravljanje) moraju zajednički raditi kako bi pružile učinkovitu odgovornost i kvalitetnu reviziju - stoga bi daljnja istraživanja trebala zajednički razmotriti takav utjecaj i pokušati upotrijebiti dodatne nezavisne varijable. Praktična implikacija je da se upravljanje javnim sektorom ne može determinirati kao jedini faktor koji uzrokuje odgovornost ili pitanja revizije.

Ključne riječi: *financijski menadžment, kvaliteta revizije, vodstvo, upravljanje, upravljanje rizikom, čisti ishodi revizije.*

