

Relationship between Municipal Governance and Assurance Quality

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This paper examines the relationship between municipal governance quality and assurance quality. The paper's pertinence lies in the deteriorating state of municipal service delivery and the Auditor General South Africa's (2016) recurring reporting of poor financial management in the vast majority South Africa's municipalities. Hence, the objective of the paper is to analyse the relationship between municipal governance quality (with quality of performance reports as the proxy) and the municipal assurance quality (with financial statement quality as a proxy). Data was collected from the archives of the Auditor General's consolidated municipal audit reports for the 2016/2017 and 2017/2018 fiscal years. The data was subjected to quantitative analysis using the fixed and random effects panel data regression methods. Findings from the statistical analysis in both models show that the quality of performance reports is significantly related to the quality of assurance, with a p value of less than 0.05. The findings suggest that real improvement in municipalities' public service delivery and financial management depends on the level of improvement in governance quality, and the latter requires that bureaucrats tackle the now perennial issue of poor governance quality. This paper offers practical and research-based recommendations, most important of which is the need to implement quarterly quality-of-governance and assurance checks in the municipalities, thus avoiding the extended delays associated with the annual audit cycle. The second recommendation is for further research to examine the relationship between governance quality and assurance quality in the national government sphere, to determine the degree to which the challenges experienced are similar to those at the municipal level.

Key Words: financial statement, financial management, municipal governance, assurance report, performance report, service delivery

JEL Classification: H79, H83

<https://doi.org/10.26493/1854-6935.18.285-300>

Introduction

There is a growing recognition that the heart of good working relationships within and between municipal structures requires (and generates) good governance practices. Such relationships ought to be built on effective communication systems, monitoring systems and interactions within governance structures (Wong 2017). Meanwhile, municipal governance oversight has become an integral part of municipal administrations (Nealer 2009), and trust of governance structures should be built to ensure that accountability becomes a reality (Schmidt and Zakayo 2018). Jackson (2018) states that establishing effective and accountable governance structures and processes are at the core of building good municipal government. Although municipalities are complex institutions with a wide range of powers and duties, this paper addresses the important issue of knowing who the officials and role-players in municipalities are and understanding their duties and responsibilities. According to Ter Bogt (2018) councillors, mayors and other administrative functionaries in municipal structures are key to the successful implementation of controls in municipal governance. Grimmelikhuijsen and Feeney (2017) explain that municipal governance more often than not, is seen as the reviewing of the municipality's compliance with its own policies, rules and regulations, while Matovu (2018) states that the key role of municipal governance structures is to be conscious of and proactive about the state and implementation of municipal laws and regulations. Van der Jagt et al. (2017) state that these role players should have an understanding and appreciation of both budgets and financial information in order to provide insightful support. Guragain et al. (2017) further observe that effective working relationships within municipal authorities are a key aspect of effective municipal governance. However, it is unfortunate, but true that some key governance structures within municipalities conduct their oversight work without an appreciation or understanding of budgets and financial information, and with no formal interaction with each other. Hence, this paper investigates the role-players associated with municipal governance in South African municipalities. Davies (2009) states that good working relationships are the cornerstones of effective municipal governance. According to Nurudin et al. (2017) the strength of the state rests largely on its ability to implement good governance principles and this then helps in the building of good relationships (Davies 2009). According to Goddard (2005) establishing such professional relationships contributes to the achievement of good governance and accountability.

Whiteoak (1996) observes that the responsibility to report on financial management and to audit management rests with internal and external assurance providers, and Motubatse (2016) observes that the strength of assurance and the quality of formal communications within an entity are mutually supportive. Despite the fact that assurance providers have a good level of understanding of the business environments in which they operate, poor coordination of work assignments and a lack of accountability among various assurance providers are still widespread.

Poor governance impacts negatively on both accountability and transparency (Chowdhury 2017). Porumbescu (2015) observes that local government structures should view transparency and accountability as means of connecting with their public/customers. According to Leck and Roberts (2015) those entrusted with municipal governance are the enablers of municipal administration. Natal'ya et al. (2016) state that the condition of municipal administration is reflected in the quality of the governance structures: if these are performing their roles effectively in supporting the administration, the administration will be similarly effective and efficient. For example, if governance structures such as audit committees and public accounts committees are able to achieve an improved and improving level accountability in key assurance providers (Degeling, Anderson, and Guthrie 1996), this is usually because they understand how assurance providers perform their work in local municipalities (Davies 2009).

Therefore, the objective of this paper is to examine the relationship between municipal governance and the quality of assurance the municipality is provided. Hence, the research question is whether a significant relationship exists between the quality of municipal governance and the quality of assurance the municipality receives.

The rest of the paper is organized as follows: the next section presents a literature review covering the diverse concepts addressed in this paper. Thereafter, the research method and the results are presented. The final section of the paper presents the conclusion and identifies some issues requiring further research.

Literature Review

GOOD GOVERNANCE

In many respects, good governance will eventually improve relationships between governance structures and municipal service delivery structures, and create a workable environment thus enabling municipalities to achieve their service delivery targets. However, good governance is

not only important for the smooth-functioning of municipalities, it is also important for the public as well. To begin with, good municipal governance improves the public's confidence in the municipality. According to Rotberg (2014), good governance means efficient performance and delivery of positive results, and good governance codes usually end with a list of agreed public values (De Graaf and Paanakker 2015). Of particular interest in this respect is the role of local councillors. As elected representatives, councillors embody the commitment of authorities towards the public (Aars and Fimreite 2005). Cash (2016) explains that good governance is essentially the equitable, sustainable and efficient use of resource. According to Leitão, Alves, and Pereira (2016) good governance includes the right to participate in the process of agenda-setting and in decision-making. De Roo (2017) also contends that participatory decision-making and shared governance processes should be the cornerstone of good governance. This need (and often leads to) open, innovative governance structures, and transparency in municipalities' affairs (Leitão, Alves, and Pereira 2016).

MUNICIPAL PUBLIC ACCOUNTS COMMITTEE

Prior research has generally examined the roles fulfilled by public accounts committees in public and government sector entities. Degeling, Anderson, and Guthrie (1996) record that research into public accounts committees in Australia, as elsewhere, usually discuss and assess their contributions in terms of effectiveness in holding ministers and their departments accountable to Parliament, whereas Gilchrist and Coulson (2015) find that public accounts committees' work compliments the work of the Auditor-General by following up on issues reported with respect to performance information and financial management. Pelizzo and Kinyondo (2014) investigated the statutory roles of public accounts committees in Eastern and Southern African states, and found that the committees all have the power or authority to examine accounts and financial affairs.

Chohan and Jacobs (2016) examine how an institution's public accounts committee fulfils two important roles: first, it assists in the oversight of the budget preparation process; and second, it supports coordination efforts among key accountability institutions, such as the public accounts committee and the Auditor-General, in their fiscal oversight roles. Chohan and Jacobs (2016) also found that the budget preparation and monitoring process fits very well into the committee's commit-

ment to enhancing accountability of constitutionally established entities by strengthening these institutions. Thus, the public accounts committee is usually recognised to be at the centre of financial accountability (Degeling, Anderson, and Guthrie 1996). In a study of public accounts committees in Eastern Africa, Pelizzo and Kinyondo (2014) also validate the ideal that the committee has the potential to promote good governance, curb corruption and to increase the trust of citizens, by exercising their unrestricted rights (and obligations) to examine the economy, and the efficiency and effectiveness of policy implementation.

Moreover, the public accounts committee plays a key role in public sector accountability, and by its very nature its role is as a public spending watchdog. Within the South African municipal context, the public accounts committee is established in terms of section 79 of the Municipal Structure Act (Republic of South Africa 1998), and its key activities include oversight and interrogation of any unauthorized, irregular or fruitless and wasteful expenditure by the council, the executive mayor, executive committee or any politically appointed office bearer of the municipality (National Treasury 2006). Just as Khalo (2013, 593) affirms, the committee's function is also to restore public trust. National Treasury (2006) records that public accounts committees have a role to play in improving governance through holding local governments accountable. This can be achieved through performance monitoring, and determining the effectiveness and efficiency of service delivery efforts. As Gilchrist and Coulson (2015) conclude, the relationship between the Auditor-General and the public accounts committees should be strengthened so that when the Auditor-General provides them with reports the committees in fact do follow up, assessing the extent to which the Auditor-General's recommendations have been carried through into the day-to-day work of the executive.

AUDIT COMMITTEE

According to Beasley et al. (2009) audit committees play a key role in assisting the board to fulfil its corporate governance and oversight responsibilities with respect to a company's financial reporting, internal control systems, risk management systems and the internal and external audit functions. Gendron (2009) states that audit committees should be strong advocates of good governance, and should actively support the work of the entity's auditors (DeZoort, Hermanson, and Houston 2003). He et al. (2017), for example, examine whether social ties between en-

agement auditors and audit committee members shape audit outcomes in a predictable manner. They found that social ties between engagement auditors and audit committee members do impair audit quality. Their results show that where social ties are more prominent, governance is relatively poor and agency conflicts are more severe. Fiolleau et al. (2019) and Hoang and Pomeroy (2019) also investigate the influence of the audit committee's oversight approach on the auditors' communications to the audit committee, and their study reveals that the auditor's communication with the audit committee has the ability to build the committee's willingness to rely on the auditor's report. On the other hand, Kamarudin et al. (2018) also examine the relationships between corporate governance (focusing on chairman duality, audit committee size, independence, and frequency of meetings, and on-time financial reporting). Their study found that firms whose financial statements are released on time are more likely to have larger audit committees which have a lower proportion of independent non-executive directors; in addition, these audit committees meet less frequently, and the entities are audited by industry specialist auditors. Kamarudin et al. (2018) also found that audit committees in municipalities are being used by councils as sounding boards with respect to understanding financial information.

MUNICIPAL MANAGER

In a recent study, Connolly (2016) assesses the impact of local politics on the principal-agent relationship between the council and its manager in the municipal government arena. In terms of South African legislation such assessment serves as an important role in the initial creation of an agency relationship within the municipalities' hierarchies (National Treasury 2006). Nelson and Svara (2015) remind us that the municipal managers form part of the (sometimes fraught) political/administrative relationship. Mahdavian, Mirabi, and Haghshenas (2014) examined the impact municipal managers' strategic thinking has on the functioning of a municipality, and found that they are fundamentally important to the achievement of improvements in the performance of the municipality. However, Siegel (2015) expresses his concern that the work of municipal managers is almost always overlooked, not well understood and mostly over-shadowed by the activities of the councillors. Thus, the things that work well from the perspective of the municipal manager's office are invisible from the public's perspective (Siegel 2015).

Hirsch, Nitzl, and Schaufß (2015) studied the influence of management

accounting departments within German municipal administrations – over 743 municipalities in total. The study revealed that an effective management accounting department can only exert a positive effect when the municipal administration employs an accrual accounting regime. Examining another metric, George, Desmidt, and De Moyer (2016) surveyed 89 municipalities in Flemish speaking Belgium, and found that strategic planning improves decision quality if both top policy-makers and municipal managers are involved. Thus, the earlier the municipal manager is involved (as the person/office who is responsible for implementation of council policies) the better the outcomes.

In South Africa, the municipal manager is accountable to the council for implementing specific agreed outputs, and for the overall administration of the municipality. The municipal manager reports directly to the executive mayor and indirectly, through the mayor, to council (National Treasury 2006, 9–10). According to Dweba (2017), the municipal manager is part of the leadership team tasked with implementing municipal strategies. Liao (2018) recognises that the municipal manager is responsible for that public body’s responsiveness to citizens’ demands, and for the effective administration of the municipality. Thus, the municipal manager is accountable for the municipality’s income and expenditure, and the management of its assets; in addition, the manager must also fulfil other obligations such as ensuring compliance with all legislation applicable to municipalities. On top of this list of duties, this position is viewed as a valuable source of support and assistance to councillors in their efforts to make informed decisions.

MAYOR

Egner et al. (2018) state that the mayor has substantial influence over the governance parameters adopted by the municipality. According to Bobonis, Cámara Fuertes, and Schwabe (2016), a mayor governs the municipality from political point of view. The mayor enjoys significant discretionary power over the budget allocations of this local government sphere (Bobonis, Cámara Fuertes, and Schwabe 2016). The mayor is also expected to oversee the municipal manager’s office, ensuring that he is indeed delivering on the mandate of council, and that the agreed outputs are being achieved with the appropriate use of allocated resources (National Treasury 2006, 20). Steyvers et al. (2006) observe that the mayor functions as a pivotal player in the governance efforts of municipalities. Thus, the mayor requires great leadership and negotiating skills and expertise

to encourage all municipal councillors to work together in the interests of the municipality; additionally the mayor must also be able to provide guidance and support to efforts to resolve disputes.

MUNICIPAL COUNCIL

Maserumule (2008) recognises that municipal councillors, as members of council committees, contribute to the effective operation of this the local government sphere, and to municipal administration. As recognised by Meloche and Kilfoil (2017), municipal councillors are elected officials serving in the local government structures. Thus, the council holds the mayor responsible for achieving promised outcomes and the municipal manager for specific outputs. The Municipal Finance Management Act (MFMA) and other legislation require municipal councils to be open and transparent in the performance of their duties and deliberations, and to encourage the involvement of the local community in municipal affairs (National Treasury 2006, 13). The municipal council is the highest governing body of a municipality. The members of the council make all the major decisions affecting the municipality. This includes decisions on education, the bylaws regarding construction of new buildings, or local tax levels. Within their responsibility for the municipality's financial affairs, they have powers to pass by-laws, approve budgets and to increase municipal service fees (National Treasury 2006). According to Maserumule (2008) these councillors are expected to have the requisite knowledge to perform the specific functions associated with their office.

Research Method

Data for the research and subsequent analysis described in this article was collected from the 2016/2017 and 2017/2018 consolidated general reports on the local government audit outcomes of the Auditor General South Africa, and is required in terms of the Municipal Finance Management Act (MFMA). The data covered audit outcomes for the municipalities in all nine provinces of South Africa for the two most recently concluded financial years. The volume of data suggested it was pertinent to apply a cross sectional panel data approach, comparing outcomes from two methods of panel data regression, namely the fixed effect and random effect methods (table 1 and table 2). The motivation for using these specific data sets (the two financial years 2016/2017 and 2017/2018) arises from the AGSA's 2015 mandate to strengthen the level of governance. In his 2014/2015 municipal audit report, the AGSA lamented that governance

quality had declined and that this had contributed to the low level of service delivery in many provinces of the country. He implored municipal leaders to ensure the restoration of good governance practices in subsequent fiscal years (Auditor-General South Africa 2016).

In the following analysis, governance quality is represented by the quality of municipal performance reports; and since, according to PricewaterhouseCoopers (2014), assurance resonates with the quality of financial statement, the paper uses financial statements as a proxy for assurance quality. Thus, these two variables – quality of performance reports and quality of financial statements – were measured and reported in the audited general reports of 2016/2017 and 2017/2018. Since these variables have been certified and reported by the Auditor General, these variables are thus deemed to be valid.

Results and Discussion

The main objective of this research is to examine the relationship between municipal governance quality and assurance quality in South African municipalities. Data reported in the consolidated municipal reports by the AGSA were collected from the AG's report archives. Table 1, table 2 and table 3 present the results of panel data regression analysis. Table 1 presents the result using the fixed-effect panel data regression; table 2 present the result for random-effect panel data regression. The purpose of using the two methods is to select the method that gives the best result, using the indicators generated by the Hannan-Quinn ratio, Akaike criterion ratio and the Schwarz criterion ratio (also presented in tables 1 and 2). Expert recommendation is that the alternative with lower ratios of Hannan-Quinn and Akaike criterion and the Schwarz criterion is a better model (Anderson, Burnham, and White 1998). Accordingly, a comparison of the indicators generated by these three model show the following: Schwarz criterion is 124.76 in the fixed effect model and 115.07 in the random effect model; Akaike criterion is 115.85 in the fixed effect model and 113.29 in the random effect model; Hannan-Quinn is 117.08 in the fixed effect model and 113.53 in the random effect model. Based on these comparisons, it is clear that the random effect model (table 2) presents the best regression model to analyse the link between governance quality and assurance quality. Therefore, although the two models show a significant relationship between governance quality and assurance quality, the conclusions drawn in this paper are based on the random effect model (table 2).

TABLE 1 Result of the Relationship between Quality of Performance Report (QPerfRep) and Financial Statement Quality (FSQ): Model 1

Item	Coefficient	Std. Error	<i>t</i> -ratio	<i>p</i> -value
Const.	4.34745	2.12739	2.0436	0.07526*
QPerfRep	1.14471	0.182984	6.2558	0.00024***
Mean dependent var.	15.22222	SD dependent var		11.02167
Sum squared resid.	216.5686	SE of regression		5.202988
<i>R</i> ²	0.895130	Adjusted <i>R</i> ²		0.777151
<i>F</i> (9, 8)	7.587196	<i>P</i> -value(<i>F</i>)		0.004482
Log-likelihood	-47.92872	Akaike criterion		115.8574
Schwarz criterion	124.7611	Hannan-Quinn		117.0851

NOTES Model 1: Fixed-effects, using 18 observations. Included 9 cross-sectional units. Dependent variable: FSQ.

At an alpha level of 0.05, table 2 shows that quality of the performance report (a proxy for governance quality in this paper) is significantly related to financial statement quality (a proxy for assurance quality) at a *p*-value of 0.00001, which lower than 0.05. This indicates the relationship enjoys a high level of significance, and shows that municipal governance quality does have a high influence on the quality of assurance provided, which in turn resonates with the quality of audited and published financial statements (holding other factors constant). This finding concurs with research based on private sector entities' reports, in which it was found that corporate governance quality affects the quality of audited financial statement (Cohen, Krishnamoorthy, and Wright 2002). Table 3 presents the model's validity tests, namely the Breusch-Pagan test for heteroskedasticity, the Hausman test for endogeneity, and the normality test. The results from table 3 show the following *p*-values: 0.87, 0.92 and 0.91 for Breusch-Pagan, Hausman and normality tests respectively. Since these *p*-values are all above the alpha level of 0.05, this indicates that there is no heteroskedasticity, no endogeneity and that variables are normally distributed. Therefore, table 3 adds validity to the research results.

Conclusion

This paper has evaluated the relationship between municipal governance quality (with performance quality as its proxy) and the municipal assurance quality (using financial statement quality as its proxy). According the AGSA, South Africa's municipalities' levels of performance regarding

TABLE 2 Result of the Relationship between Quality of Performance Report (QPerfRep) and Financial Statement Quality (FSQ): Model 2

Item	Coefficient	Std. Error	t-ratio	p-value
Const.	4.42643	1.94159	2.2798	0.03667**
QPerfRep	1.1364	0.148217	7.6671	<0.00001***
Mean dependent var.	15.22222	SD dependent var		11.02167
Sum squared resid.	456.8726	SE of regression		5.184097
Log-likelihood	-54.64719	Akaike criterion		113.2944
Schwarz criterion	115.0751	Hannan-Quinn		113.5399

NOTES Model 2: Random-effects (GLS), using 18 observations. Included 9 cross-sectional units. Dependent variable: FSQ.

TABLE 3 Validity Tests

Breusch-Pagan test	Null hypothesis: Variance of the unit-specific error = 0 Asymptotic test statistic: $\chi^2(1) = 0.0239722$ with p-value = 0.876956
Hausman test	Null hypothesis: GLS estimates are consistent Asymptotic test statistic: $\chi^2(1) = 0.00824316$ with p-value = 0.927658
Test for norm. of residual	Null hypothesis: error is normally distributed Test statistic: $\chi^2(2) = 0.172386$ with p-value = 0.917417

service delivery, compliance with regulations and financial management has deteriorated over the years. Hence, in 2015, the AGSA highlighted the urgent need to improve the quality of municipal governance as this was recognised as a catalyst for improving municipal performance (service delivery). This AGSA report prompted this paper, the purpose of which was to determine whether the level of governance quality in 2016/2017 and 2017/2018 had contributed to an improvement in the assurance quality. Two models of panel data regression analysis were presented and both models show p-values of less than the alpha level of 0.05. This then shows that the quality of governance has a significant effect on the assurance level as reflected on the quality of the financial statements for the years 2016/2017 and 2017/2018. This finding compares favourably with research findings from the private sector. Thus this indicates that municipalities will be able to improve their service delivery levels and the quality of their

financial management if there are improvements in their governance. The implication for municipal governance is that in order to improve governance quality, service delivery and the management of public funds, those in charge of appointing municipal leadership should consider appointing only personnel with relevant knowledge and experience. Doing so will increase the social and economic welfare of citizens and general economic growth.

A practical recommendation in support of this desire for improved governance is the recommendation that municipalities be required to undergo quarterly quality-of-governance and assurance checks, without waiting for outcomes of the AGSA's annual audits. Such a quarterly governance and assurance quality audit will identify quality weaknesses in key positions of leadership and allow for immediate corrective plans and actions to be undertaken, while the problems are still current, and before such weaknesses accumulate into enormous service delivery problems, and financial costs that are ultimately to the detriment of the citizens. In addition to this practical recommendation, the authors of this paper recommend that further research is undertaken to examine the relationship between governance quality and assurance quality at the national government level, to see if the same results apply. If the problems are similar to those identified at the municipal level this might then prompt the search for solutions that are more generally applicable.

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