Article

The Audit Committee Anomaly in South African Local Governance

Lourens J. Erasmus
http://orcid.org/0000-0003-3692-9586
University of South Africa
erasmlj1@unisa.ac.za

Thabo Matsimela
http://orcid.org/0000-0003-1143-4114
University of South Africa
matsict@unisa.ac.za

Abstract

Stakeholders of organisations have to rely on the credibility and effectiveness of governance by management and oversight structures, such as the audit committee, to protect their interests. The role of the audit committee is globally accepted to be one of oversight and monitoring of management. In contrast, the Municipal Finance Management Act, 56 of 2003, requires a South African municipal audit committee to be an independent advisory committee to management. Our research objective was to argue that an anomaly exists in the Municipal Finance Management Act regarding audit committees' role in that it deviated from the globally accepted norm. This conceptual article follows an interpretive approach, which includes a document analysis to establish the prevalence of the audit committee advisory expectation and thereafter to argue from theoretical perspectives whether the audit committee's function to advise municipal management in particular has validity. Our conclusion suggests that legislators should consider amending the Municipal Finance Management Act to reflect audit committee best practice or changing the reference to the municipal audit committee to that of an advisory committee so as to avoid misleading local communities in terms of what they may perceive as good governance practice. Thus this article informs legislators of a possible governance anomaly in South African legislation.

Keywords: advisory function; Municipal Finance Management Act; municipal audit committee; oversight function

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Introduction and Contextualisation

> An audit committee is essentially an oversight committee, for it is management who are responsible for the internal controls and the financial statements. The committee, however, has to satisfy itself, on behalf of the board and ultimately the shareholders, that key controls are operating, that ethical practices are being reinforced, that key accounting estimates and judgements are being properly made and that internal and external audits are effective. (Audit Committee Institute 2017, 1)

The first subcommittees of governing bodies of organisations, regarded as audit committees, were established in the United States (US) following McKesson and Robbins Inc.'s financial misrepresentation scandal (Securities and Exchange Commission (SEC) 1940). During the 1950s, the idea of an audit committee received very little attention, and the functions of the audit committee remained undefined (Carey 1953). The status quo persisted up to the 1970s when the role and responsibilities of audit committees received a great deal of attention in the US because of the post-Watergate revelations of corporate slush funds, illegal political contributions, and overseas bribes (Berger and Tausanovitch 2018). Thus, stakeholders demanded greater corporate accountability to increase confidence in the quality of financial reporting, as well as more assurance with respect to both the internal and external auditing processes.

In the decades that followed, many developed countries responded to stakeholder demands, requesting the establishment of audit committees through endorsement by the SEC in the US (Burton 1973), legislation in Canada (Ontario 1970) and codes of best practice in the United Kingdom by the Cadbury Committee (Committee on the Financial Aspects of Corporate Governance 1992). However, major corporate scandals continued unabated, such as those of the US energy company Enron in 2002 (Ahluwalia et al. 2016) and the South African companies Sharemax in 2010 (Heystek 2015) and African Bank in 2014 (Donnelly 2016), to name a few. After each scandal the investing public demanded more corporate accountability. Accountability demands, together with an increasing amount of academic literature on the phenomenon of the audit committee, caused stakeholders' expectations of the audit committee to evolve over time.

As pressure on regulation for improved governance mounted, because of corporate failures and the "new public management" drive in governments to incorporate private-sector practices (Cameron 2009), South African legislation (RSA 1999, 2008), which includes the Municipal Finance Management Act, 56 of 2003 (hereafter MFMA) (RSA 2003), incorporated the establishment of an audit committee. With the exception of the MFMA, however, other legislation (RSA 1999, 2008; USA 2002) shares a common expectation in line with the global norm when referring to the role of the audit committee, namely that of oversight.

The MFMA requires the establishment of an audit committee that has an independent "advisory" function (RSA 2003), as opposed to an oversight function, to advise municipal management. Considering that the effectiveness of South African municipal audit committees is under scrutiny owing to continuous negative audit findings (Auditor-General of South Africa 2017), it may be fitting to contemplate this deviation in their role from best practice. The research problem for this study was thus the anomaly in the MFMA regarding audit committees' role, and the research objective was to argue that South African municipal audit committees deviated in their role from the globally accepted norm.

This conceptual article follows an interpretive approach. We analysed documents to establish the prevalence of the audit committee advisory expectation. Relevant literature informs our argument relating to the validity of the audit committee as having the function of advising management. Having analysed the documents (see Table 1) we deduced that the description of the function of the audit committee had evolved over time: during the 1990s the audit committee was described as having an "advisory function" (Conseil National du Patronat Français / Association Française des Entreprises Privées (CNPF / AFEP) 1995; Institute of Directors (IoD) 2002) but since then it has been described as having an "oversight function" (Contessotto and Moroney 2014; IoD 2016). The global expectation today is that an audit committee is independent and oversees the quality of financial reporting and of internal control and risk management, ensures the independence and quality of external and internal audits, and provides assurance of good governance practices to stakeholders (Salehi and Shirazi 2016).

Table 1 lists different countries' regulated and best-practice requirements in terms of audit committees' advisory and oversight functions. A clear picture emerges of a general migration towards describing the function of the audit committee as being one of "oversight" since the late 1990s to the middle of the first decade of the new millennium.

Table 1: The description of the audit committee as having an "advisory" or "oversight" role

No.	Country	Legislation and guidance reports	Oversight or advisory role
1.	South Africa (RSA)	King I Report, 1994 (IoD 1994, 51–52, App. V)	An audit committee is meant to assist a board **(advisory).**
2.		King II Report, 2002 (IoD 2002, 67, Ch. 8, App. V)	An audit committee is meant to assist a board **(advisory).**
3.		MFMA (RSA 2003, sec. 166(2))	The role of an audit committee is explicitly stated as **advisory.**
4.		Treasury Regulations, 2005. (RSA 2005, sec. 3.1.10)	It can be inferred that the duties of an audit committee consist of **oversight** and monitoring.

5.		Companies Act, 71 of 2008 (RSA 2008, sec. 94)	There is a clear indication of **oversight** and monitoring.
6.		King III Report, 2009 (IoD 2009, principle 3 (3.1–3.10), 2.23, recommended practice 3.1.1–3.10.4, 2.23.4–2.23.5)	An audit committee should monitor a board by performing an **oversight** role.
7.		King IV Report, 2016 (IoD 2016, principle 8, recommended practice 51)	The role of an audit committee is explicitly stated as one of **oversight**.
8.	France	Vienot Report, 1995 (CNPF and AFEP 1995, 20 recommendation III (3))	The role of an audit committee is explicitly stated as **advisory.**
9.		Corporate Governance of Listed Corporations, 2003 (AFEP and MEDEF 2003, principle 14)	It can be inferred that the duties of an audit committee consist of **oversight** and monitoring.
10.	USA	Sarbanes-Oxley Act of 2002 (USA 2002, section 301 (2))	The role of an audit committee is explicitly stated as one of **oversight.**
11.	United Kingdom	Cadbury Report, 1992 (Committee on the Financial Aspects of Corporate Governance 1992, 22 sec. 4.33)	It can be inferred that the duties are those of **oversight** and monitoring.
12.	Canada	Macdonald Report, 1998 (Canadian Institute of Chartered Accountants 1998, ch. 4, para. 4.5–4.28)	It can be inferred that the role of an audit committee includes monitoring and **oversight**.
13.	Australia	Corporate Governance Principles and Recommendations, 2014 (ASX Corporate Governance Council 2014)	It can be inferred that the duties of an audit committee are those of **oversight** and monitoring.
14.	Netherlands	Peters Report on Corporate Governance, 1997 (Committee on Corporate Governance 1997, recommendations 3.2 and 6.4 (read with 6.3))	It can be inferred that the duties are **advisory** in nature.
15.	New Zealand	NZX Corporate Governance Code, 2017	It can be inferred that the duties are those of **oversight** and monitoring.

		(NZX 2017, principle 3, recommendation 3.1)	
16.	Hong Kong	Corporate Governance Code and Corporate Governance Report, 1998 (Hong Kong Society of CPAs and the Stock Exchange of Hong Kong 1998, principle C. 3, code provision C. 3.3)	The role of an audit committee is explicitly stated as one of **oversight.**
17.	India	Desirable Corporate Governance: A Code 2002 (CII 2002: recommendation 8)	It can be inferred that the duties are **advisory** in nature.

Based on the document analysis it may be appropriate to put in perspective the reference to an advisory function. An audit committee functions as a subcommittee of a governing body (Collier and Zaman 2005) such as the board of directors of a company. As such, it may be safe to assume that the advisory function referred to in Table 1 refers to the task of an audit committee to advise a governing body (not management) on its oversight of the management of the entity in areas of governance, which include ensuring the quality of financial reporting, the quality of internal control and risk management and the independence and quality of external and internal audits. In other words, reference to the oversight function refers to the audit committee's performance of an oversight role on behalf of the governing body in terms of the aspects alluded to in the preceding sentence. Whichever way the role is described, ultimately stakeholders have to rely on the credibility and effectiveness of governance by management and oversight structures, such as the audit committee, to protect their interests. After all, a competent, committed, independent and tough-minded audit committee is one of the most reliable guardians of public interest (Beasley et al. 2009).

In the remaining part of the article we focus on the meaning of the term advisory and its link to the function of consulting, as well as on the meaning of the term oversight and its link to the functions of monitoring and assurance. We also consider the current environment of the South African municipal audit committee with a view to justifying its function as an independent advisor to management.

Conceptual Framework

Figure 1 presents the concepts and theories used as analytical lenses through which to argue the relevance of the municipal audit committee in functioning as an independent advisor to management.

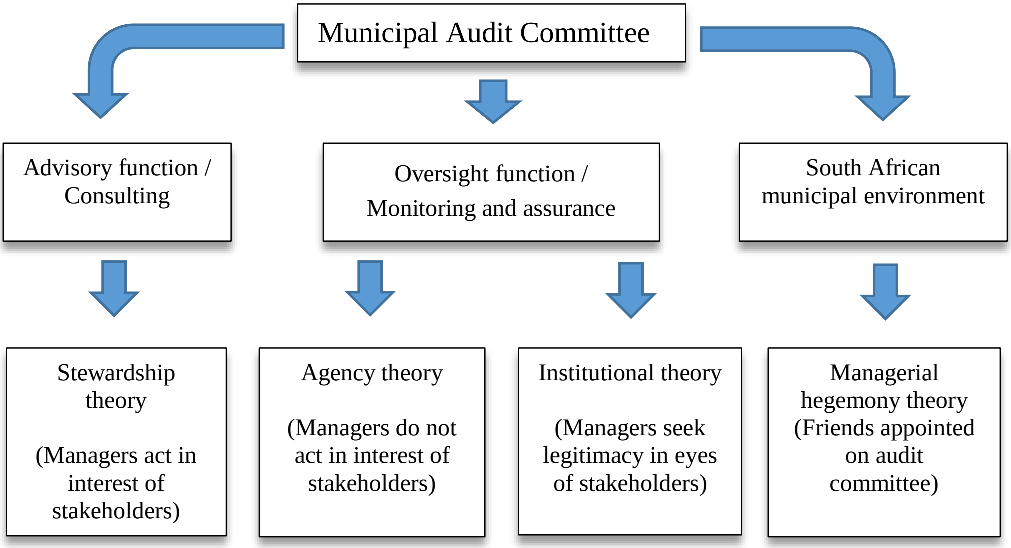

Figure 1: Conceptual framework

Advisory Function: Consulting

The stewardship theory presumes that managers are honest, capable stewards of an institution's resources (Nicholson and Kiel 2007). The focus is on management's ability to promote stakeholder interest through their superior knowledge of the institution. From the perspective of the stewardship theory it can thus be deduced that stakeholders of an institution would not require an independent body or function to monitor management, since management would always act in the best interest of the institution's stakeholders. The stewardship theory could therefore apply in terms of the MFMA advisory requirement according to which an audit committee is expected to assist management rather than to monitor management.

However, considering the earlier reference to the evolution of the role of the audit committee due to corporate scandals, the stewardship theory is contested in terms of the assumption that management acts in the interest of the stakeholder. A case that may have had a major influence on the evolution of the role of the audit committee was arguably one of the most highly publicised corporate failures—the collapse of the Enron Corporation. Enron was one of the biggest external audit clients of Arthur Andersen, a large auditing firm (Asthana, Balsam, and Krishnan 2009). However, Arthur Andersen did not function independently of Enron—it advised Enron and participated extensively in almost all Enron's transactions (Vinten 2002) to the extent that Arthur Andersen appeared to be auditing itself by being both the client and the external auditor. At the federal trial in the US in May 2002, the engagement partner responsible for Enron was referred to as a "client pleaser" by Arthur Andersen's lawyer (Vinten 2002). This lawyer insinuated that the audit partner compromised itself and the auditing firm to keep the client (Enron) happy. This was necessary, however, since a significant part of Arthur Andersen's revenue was earned from Enron (Vinten 2002).

Raghavan (2002) noted that Arthur Andersen's Professional Standards Group was not effective in raising issues about Enron's accounting treatment of certain questionable transactions. Vinten (2002) held the same view, claiming that where matters concerning the treatment of certain questionable transactions were raised, the client's (Enron's) view tended to prevail. Similarly, Raghavan (2002) noted that Enron had undue influence on the staffing of the external audit team of Arthur Andersen. This was evident from the fact that Enron lobbied for a member of the Professional Standards Group of Arthur Andersen to be removed from the audit.

As far as South African municipal audit committees are concerned, much can be learnt from the Enron case. An external auditor is required to be independent and provide objective assurance about the accuracy of financial reporting; similarly, a modern audit committee needs to adhere to the same independence principles to provide assurances to the governing body and stakeholders about aspects of governance, risk management and control processes. Thus, it can rightly be asked whether it is possible to establish an "independent" advisory committee to management. Independence on paper may be possible, but a lesson learnt from the Enron case is that it is certainly questionable whether audit committee members providing advice to management, possess the "independence of mind" (i.e., objectivity) to make a true contribution to governance.

Following the demise of Enron in the US, the Sarbanes-Oxley Act (USA 2002) was signed into law (Asthana, Balsam, and Krishnan 2009). This Act prohibits independent auditors from performing consulting and advisory services for their clients, as was the case between Enron and Arthur Andersen. The reason for this prohibition is because of the possibility of creating a conflict of interest and of the self-review threat to the auditors' independence (South African Institute of Chartered Accountants 2018).

The same problem may apply to a South African municipal audit committee if it wants to regard itself as an audit committee according to globally accepted norms. Fulfilling the role of advisor to management renders an audit committee a consultant to the municipal management, rather than an overseer that monitors and solicits accountability from management on behalf of the governing body (municipal council). If the expectation is that the audit committee should, in addition to its advisory role, perform oversight and provide assurance on the municipality's governance, risk management and control processes, a self-review threat will arise as the audit committee will provide assurance on processes that the audit committee itself advised the municipal management on.

Oversight Function: Monitoring and Assurance

The oversight function entails the activity of an actor, called the "overseer," in overseeing another actor, called the "overseen." Whereas the process through which the "overseer" oversees the "overseen" is called oversight, the converse process through which the "overseen" accounts for its choices, actions and decisions is called accountability (Kiyondo, Pelizzo, and Umar 2015). Kiyondo, Pelizzo and Umar (2015) confirm that the purpose of the oversight process is precisely that of enabling the overseer (audit committee) to ascertain whether the overseen's (management's) actions concur with the expectations of its stakeholders—thus providing the stakeholders with accountability. Where a case can be made for the oversight role of the audit committee, there are several theories, often competing but sometimes complementary, that may apply to audit committees (Beasley et al. 2009). For the establishment of an audit committee, the most prominent theories are the agency theory (Beasley et al. 2009; Jensen and Meckling 1976) and the institutional theory (Cohen, Krishnamoorthy, and Wright 2008; Spira 2002).

The agency theory holds that the board (e.g., the municipal council) and audit committee are in place to monitor management (the agent), who may otherwise act in their personal interest and not in the interest of the principal (the shareholders/community). Jensen and Meckling (1976) argue that the lack of goal congruence, that is, when managers engage in activities for their own benefit rather than for the benefit of stakeholders, creates agency problems. Agency problems, in this instance, refer to information asymmetry (Fama and Jensen 1983). Jensen and Meckling (1976) further argue that agency problems can be reduced by putting into force the contractual obligation to provide an independent body (e.g., an audit committee) to monitor the agent while reporting to the principal. For a municipal setting, it can thus be deduced that the audit committee should provide the municipal council (i.e., the principal—proxy for the community) with assurances that management is acting in the best interest of its community.

The institutional theory offers another relevant perspective on audit committees. This theory views the audit committee as ceremonial in nature, with specific focus on the legitimacy of the governance process instead of on the actual monitoring of management (Cohen, Krishnamoorthy, and Wright 2008). An institutional theory view of governance considers how organisational processes change over time (Scott 1987) and how governance structures fulfil ritualistic roles that help legitimise the interactions between the various actors within the governance arena (Cohen, Krishnamoorthy, and Wright 2008). In terms of this view of governance, audit committee processes may become the same over time (Barreto and Baden-Fuller 2006; Dacin 1997) as organisations are coerced into becoming similar through regulation (such as the Sarbanes-Oxley Act (USA 2002) or the MFMA (RSA 2003)), through following best practices (such as the King reports (IoD 1994, 2002, 2009, 2016)) or through mimicking other organisations to enhance their legitimacy (Cohen, Krishnamoorthy, and Wright 2008).

Accordingly, Beasley et al. (2009) questions whether audit committees appear to provide substantive oversight of financial reporting or whether they appear to be primarily ceremonial bodies designed to create legitimacy. Kalbers and Fogarty (1998, 131) state that in terms of the ceremonial view, "organisational structures … become symbolic displays of conformity and social accountability." In other words, some governance activities and structures may be driven by a desire to foster legitimacy; therefore, the activities and structures are primarily ceremonial and serve as symbols of effective oversight. Cohen, Krishnamoorthy, and Wright (2008), however, note that where an audit committee's role is primarily ceremonial, the committee's symbolic efforts can also lead to effective questioning of management. Thus, from an institutional theory perspective, there may still be value in terms of the oversight role, but, in the context of this article, it appears to be more applicable to the symbolic establishment of audit committees. A municipality may be required to establish an audit committee to conform to the generally accepted norm of having an audit committee as a pretence of good governance, when, in reality, the audit committee fulfils a different role from what may be assumed by the stakeholder.

The South African Municipal Environment

The discussion thus far begs the question why the drafters of the MFMA wished the municipal audit committee to act as an advisory committee to management, contrary to international best practice. The question is even more relevant when one considers the requirement of the Public Finance Management Act, 1 of 1999 (RSA 1999) (which was promulgated before the MFMA and is applicable to national and provincial government departments) that audit committees should fulfil an oversight role in accordance with Treasury Regulations (RSA 2005). A review of the current South African municipal environment in terms of audit committee members and their appointments may provide insight into this question.

Although the MFMA requires a municipal council to appoint audit committee members, it appears to be standard practice for the council to approve appointments on the recommendation of a municipal manager, which certainly may influence the independence of the audit committee members from the management of the municipality. This practice is confirmed by the Overberg District Municipality's (2018, 1) audit committee's terms of reference, which reads: "The replacement [of an audit committee member] shall be at the discretion of the council on the recommendation of the municipal manager in conjunction with internal audit." Municipalities may have borrowed this practice from national and provincial government legislation (RSA 1999) that requires the accounting officer of a government department (equivalent to a municipal manager) to appoint audit committee members.

There are other influences on the independence and objectivity of municipal audit committee members. One of them concerns the appointment of ex-councillors to the audit committee. During a conversation between a municipal audit committee chairperson and one of the authors of this article, the chairperson alleged that there was a tendency to appoint to the audit committee ex-council members who had lost their seats after elections, thus securing an income for those particular individuals. Secondly, a contemporary concern is whether certain individuals in the South African public sector may be regarded as “professional” audit committee members as they derive their income from serving on audit committees. If the practice of “professional” audit committee members is indeed prevalent, these audit committee members will in all likelihood not act in a manner that could jeopardise their appointment—especially if the municipal manager has any say in the appointment. As a result of audit committee members’ wish not to jeopardise their livelihood, their independence and objectivity may be impaired.

Judging from the scenario mentioned above, the managerial hegemony theory may apply in terms of the South African municipal audit committee. The managerial hegemony theory asserts that members of management (e.g., a municipal manager) choose friends to serve as passive directors (i.e., audit committee members) who derive all of their information from management (Cohen, Krishnamoorthy, and Wright 2008). In support of the theory, Bruynseels and Cardinaels (2014) have found that many US-listed company audit committees appear to be fully independent, but that anecdotal evidence suggests that chief executive officers (CEOs) often appoint directors (who become audit committee members) from their social networks. Furthermore, firms whose audit committees have friendship ties with the CEO purchase fewer audit services and engage more in earnings management. Drawing on the managerial hegemony theory, it can be said that the audit committee becomes purely symbolic and consistently supportive of management, even when the members appear to be independent. For the purposes of this article, it is assumed that an audit committee is appointed by a municipal council, with considerable influence from management, whose members may choose to nominate friends that are completely under management’s control and who may even struggle to provide any substantial advice as required by the MFMA.

In searching for a reason for the current MFMA requirement we reviewed past research and found that studies have identified factors leading to the dysfunction of municipalities, for example, lack of financial management skills and the appointment of officials with skills that are irrelevant to their positions (Ngwakwe 2012; Shiceka 2009; Tshishonga 2011). This is certainly a scenario that may support the requirement for an advisory body. Rural municipalities may struggle to source and retain highly qualified workers, especially those with financial management expertise, since such individuals may prefer a career in the more prosperous metropolitan areas. One way in which expertise may be “purchased” to serve a municipality may be through a body of adequately qualified individuals who can assist the council and management of the municipality in the execution of their legislative mandate. Thus, there may be a need in the current South African municipal environment to prioritise expert advice rather than independent oversight. Further evidence of the low priority given to the independence of an audit committee can be found in the MFMA (RSA 2003), which allows for at least one member (out of the required minimum of three members) of the audit committee to be in the employ of the municipality. This legislative requirement is contrary to globally accepted corporate governance practices according to which all members of the audit committee must be independent of the organisation (Canadian Institute of Chartered Accountants 1998; IoD 2016; USA 2002).

Conclusion and Recommendations

The globally accepted role of the audit committee is one of oversight, monitoring management and ensuring accountability on behalf of the organisational stakeholder. If the South African legislature regards the municipal audit committee as having an oversight function that, drawing on the agency theory, provides assurances to the municipal council about the quality of financial information, risk management, the control environment and the effectiveness of the internal and external audit functions, it must consider amending the MFMA to reflect the oversight requirement in line with global best practice. Currently, the establishment of municipal audit committees appears to be drawing on the institutional theory, which purports that some governance activities and structures are primarily driven by a desire to foster legitimacy in the eyes of the community. If, in reality, the appointment of municipal audit committee members is supported by the managerial hegemony theory, the South African government will need to address the situation in earnest, as it may have a negative impact on effective governance and ultimately on service delivery. The mere applicability of the theory defies the purpose of an audit committee.

Whether current municipal audit committee members understand their legislative role or whether they have ever contemplated the implication of the MFMA requirement is questionable. Informal findings suggest that municipal audit committee members may regard their role as one of oversight (due to their familiarity with global best practice), regardless of the legislative requirement. Future research could seek confirmation of this phenomenon. If, however, the South African municipal audit committee is truly expected to act as a committee of qualified consultants, legislators should, in order to address the challenges faced by under-skilled municipal councillors and municipal managers, consider changing the name of the committee, since it is certainly not an audit committee in terms of the modern understanding of such a committee and in terms of authoritative best practice guidance.

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