

## AUDIT INCIDENTS FOR SELECTED LOCAL AUTHORITIES IN MALAYSIA

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*Abstract:* This study examines the audit certificates and financial statements of selected local authorities. The main aspects emphasized in the study are the types of report issued and audit incidents exist in the certificates. 51 of the selected local authorities were analysed for eleven years from year 1990 to 2000, i.e. 561 audited financial statements. Audit reports were classified into three types, that is Clean Report (CR), Audit Qualification (AQ) and Comment Short of Audit Qualification (CSAQ). Based on the reports issued, most of the financial reports of local authorities did not achieve the expected standards. The types of report issued were 169 CR, 8 AQ and 384 CSAQ. Pertaining to the audit incidents there is variability in the pattern of the incidents. Some of the councils have many while some have very few incidents and some are free from any errors. This may suggest that it is not impossible to totally eliminate audit incidents and get a clean report. Possible explanations for the present of numerous audit incidents are lack of accounting skills and insufficient qualified staffs in preparing the accounts. While incidents occurs under the 'Others' category illustrates the lack of commitment and seriousness in discharging responsibilities. The numerous audit qualifications and audit comments provide evidence that the accounts were frequently violated and this is contrary to the government's expectation. Thus many local authorities should improve the quality of financial reporting and accountability to the public.

### INTRODUCTION

Local authorities serve as an important mechanism in extending the policies of the government. In addition, they serve to facilitate the implementation of relevant strategies and programs of the federal and state governments. In the context of the country's development, the administrative system of local governments plays a vital role in planning, coordinating, managing and controlling development processes at the local level (Ibrahim and Nordin, 1984) [10].

As the major service providers to the community, most of their activities involve the public, and therefore they are accountable to the public. Most of the resources used to pay for governmental operating activities are provided involuntarily through various taxes, thus a need to ensure accountability in administering those resources exists (Kidwell, 1999) [11]. Every governmental unit needs to develop good financial administration systems to ensure funds are collected, allocated and distributed in an efficient manner. Therefore, every local authority is required to account for their activities to disclose how the departments utilize public funds.

#### *Objectives of Study*

The objectives of this research are:

1. To examine and analyze the types of audit report issued to these organizations over the eleven year period
2. To examine the types of audit incidents reported by the auditors in the audit certificate.
3. To present descriptive statistical evidence of audit incidents

#### *Organization of This Paper*

Section One provides the background of this research. It highlights the importance of financial reporting. The objectives of this research are listed. Section Two covers the relevant literature of prior researches on audit incidents. Section Two also diagrammatically shows the framework of the study.

Section Three outlines the methods of data analysis used by the researchers. Section Four presents the types of audit reports received and the types of audit incidents that occurred in these organizations.

Section Five provides recommendations to eliminate audit incidents. Several future researches are suggested.

*Relevant Literature On Audit Incident*

For the purpose of reporting in Malaysia, ‘clean audit reports’ are produced, since several commentators have claimed that the auditors are reluctant to qualify their reports because it would adversely affect the interest of corporate participants. (Boh, 1993 as quoted by Othman, 2000). In addition, such auditors would naturally want to sustain their good relations with the management of the company. In conducting this research, several papers has been reviewed such as Abdul Aziz (2000) [1], Abdul Wahid (2002) [2], Bailey (1982) [3], Chandler (1986) [4], Christiaens (2000) [5].

*Framework Developed*

The framework of this study is to observe the types of audit incidents and audit lags in the local authorities. In addition, the type of council, change of auditor and type of auditor are factors to be considered in audit lags. Figure 1 illustrates the framework.

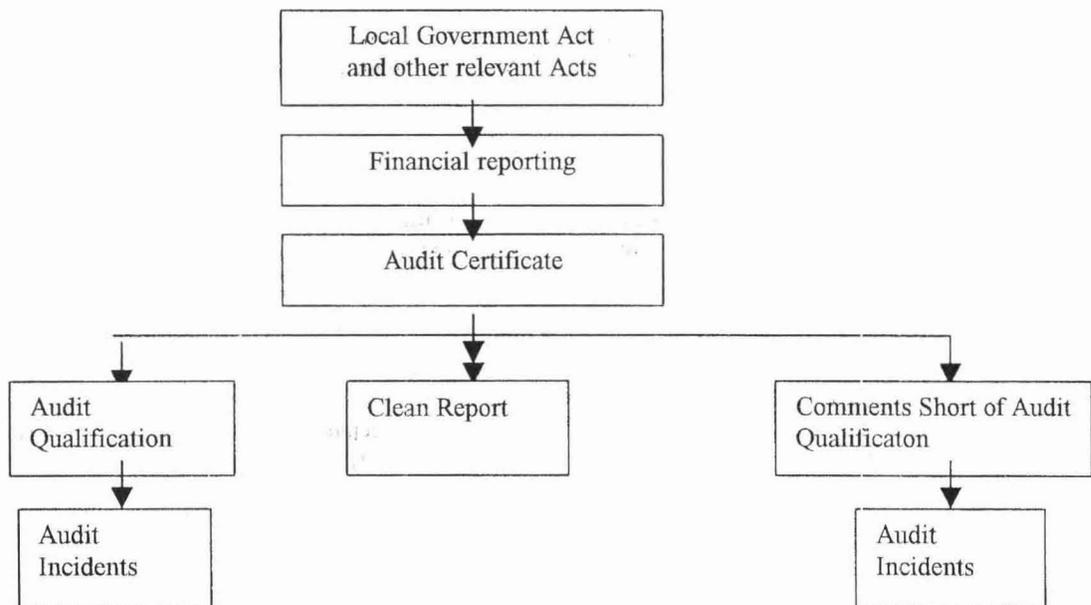


Figure 1: The Framework of Audit Incidents

**MATERIALS AND METHODS**

*Data Analysis (Audit Incidents)*

Several steps were involved in the process of analyzing the data.

- Step 1: Assessed all audit certificates and financial statements of each local authority from 1990 to 2000.
- Step 2: Determined the types of audit report issued to each local authority. Classified the reports into Audit qualification (AQ), Comment Short of Audit Qualification (CSAQ) and Clean Report (CR).
- Step 3: Extracted out all audit incidents stated in the audit certificates year by year. Information was presented in Excel Version2000.
- Step 4: Assessed and evaluated each data that had been collected. Audit incidents were classified into 2 groups – A: FINANCIAL REPORTING and B: OTHERS. For each group, audit incidents were further divided into several headings as shown in the table below.

Step 5: Assessment made on the collected data:

- Types of audit report issued across time and across local authorities
- Details of audit incidents for each local authority from the years 1990 to 2000.[6-9]
- Determine the most and least audit incidents made in the eleven year period

When all the above five steps were done, the researchers did the analysis.

## RESULTS AND DISCUSSION

### *Assessment of Audit Reports*

Audit reports were divided into three types namely Audit Qualification (AQ), Comment Short of Audit Qualification (CSAQ) and Clean Report (CR).

### *Classification of Audit Incidents*

Firstly, in order to classify the types of audit incidents, the coding system was set up in order to differentiate the types of audit incidents. The numerous audit incidents were divided into two broad categories:

- Financial Reporting
- Others

All audit incidents that relate to accounting, preparation of financial statements and non-compliance with statutory duty are classified as audit incidents on Financial Reporting. All other classifications that do not fit in category A are classified as Others (B).

### *Overview of Findings*

Table 1 reveals the disturbing persistence of numerous CSAQ which have been allowed to continue without any penalty or sanction. Numerous audit incidents are reflected as an indicator of the quality of accounts produced. These organizations have a duty of accountability to the public and to show a clean audit certificate indicating their commitment towards their responsibilities.

Table 1: Percentage for Each Audit Reports in Every States

States	CSAQ	AQ	CR
Perak	89.70	1.82	8.48
Selangor	86.36	6.06	7.58
Negeri Sembilan	92.42	1.52	6.06
Sarawak	44.70	0.00	55.30

Table 2 shows that uncollected revenue is the most frequent audit incident in the selected local authorities except for Selangor. Surprisingly, Selangor recorded "Differences Between Records" as the most frequent audit incident whereas this should not be the case. This discrepancy between records should occur because all transactions should be recorded as the amount shown in the invoices, local orders, indents etc.

Table 2: Summary of the Most and Least Frequent Audit Incidents in Each States.

States	Most Frequent Audit Incidents	Least Frequent Audit Incidents
Perak	Uncollected revenue (58.78%)	Omission of Notes & Omission of Cash Flow Statement (0.00%)
Selangor	Difference Between records (54.54%)	Omission from Notes (0.00%)
Negeri Sembilan	Uncollected revenue (69.70%)	Default in Contract (3.03%)
Sarawak	Uncollected revenue (37.88%)	Omission from Notes, Omission of Cash flow Statement, Non-compliance with IAS and other standards and Non-compliance with Sect 54(2) (0.00%)

Although omission from notes and omission from cash flow statement were found to be the least frequent audit incidents in the selected local authorities, the local authorities should not be complacent as the incidents should not have happened at all.

#### *Conclusion on Audit Incidents*

The finding from this study has shown that the financial reporting of the selected local authorities needs to be improved. Numerous audit incidents were revealed. Some of the incidents were repeated in consecutive years. As such, it was recognised, using Luder's model [12] and principal agent theory, that the stimuli to produce timely and error-free financial information is not as strong in the case of the local government as it is in the private sector, where institutional shareholders and Stock Exchange requirements make it imperative that timely information be produced. Many audit incidents do not directly or materially affect local authorities in any manner. These local authorities continue to receive financial resources from the government and the public, even if they have numerous audit comments.

Among the suggestions are workshops and seminars for the existing staff, proper training for the newly qualified staff members, extensive use of computers, close collaboration with universities, establishing audit committee or internal audit department, and clear specifications of non-compliance. It is important for local authorities to improve their current condition because they are accountable to the taxpayers.

33.33% used accounting software in the preparation of the financial statements. 76.67% were using manual systems. This also may contribute to the incomplete records and lack of supporting documents.

35.42% of the selected local authorities admitted that many adjustments needed to be done in the accounts prior to submission to AG's office. After the AG's staff had audited the financial statements, they would then return the financial statements to the local authorities for correction, thereby increasing the audit lag.

37.5% of the local authorities' staff claimed to receive assistance from the AG's staff in preparing the financial statements. Thus, many of the local authorities staff revealed that the AG's staff came to the local authorities for audit purposes only. However, in one of the states, an AG staff member mentioned that certain local authorities were 'adopted' in order to help and monitor their performance. However, in order to maintain independence, private auditors could only point out any mistakes, and correction should be done by the local authorities' staff. The situation is more difficult when most of the staff in the finance/accounts department of the local authorities do not have any accounting background. They need longer time in understanding the transactions thus contributing to a longer audit lag.

## RECOMMENDATIONS AND CONCLUSION

The focus of this research has been on audit lags in Malaysian organizations. Financial reporting delays relate to audit lags. First section describes the significance and contribution of this research to existing knowledge, gives the relationship of this research to the previous literature and identifies some recommendations. Second section discusses the limitations relating to scope and implementation of this research. Finally, the last section provides suggestions on the extension of the present research.

### *Significance Contribution of this Research*

This research is important because it reveals the worrying condition of the annual accounts of selected organizations. The numerous audit qualifications and audit comments provide evidence that the accounts do not achieve the expected standard. The statutory requirements are frequently violated and this is contrary to the government's expectations.

This research is the first extensive study on audit incidents in the selected organizations. To the researchers' knowledge, this is also the first study of its kind in Malaysia. It reveals the disturbing persistence of numerous AQs and CSAQs. The lengthy audit lags suggest that the annual accounts are not frequently used.

### *Limitation of study on audit incidents*

Initially, the study involved the assessments of financial statements and audit certificates for the year 1991 to 2000. However, some of the financial information for the year 1998 to the year 2000 was received very late and some financial reports for the year 2000 were not available, as certificates from the AG's Office had not been issued to these organizations. Thus only 51 organizations were thoroughly analysed. The research focused solely on audit certificates and therefore other financial information is not analysed. The research does not examine the date on which the accounts were received by the AG. Calculation of audit lag is based on the date that appears on the audit certificate, i.e. date of audit completion. The date on which the accounts are sent by the council to the auditor is not in the public domain.

### *Suggestions for Future Research*

There are several suggestions that could be undertaken for future research.

Firstly, from the present research, there are numerous cases of repeated audit incidents. Further research can be extended from this scenario. Future researchers may want to determine the years of repetition of particular audit incidents. By analyzing the years, the researchers can determine whether the organizations have seriously resolved all comments made by the auditors in the audit certificate. In addition, the researchers can determine the duration for the organizations to act on the comments.

Secondly, a study could be performed to analyze causal relationships. Previously this study focused only on the descriptive view. Studies can be conducted on several hypotheses regarding the quality of these organizations. For example, there might be a need to examine if the size of the organization could have a significant effect on the quality of financial reporting.

The following recommendations are proposed to ensure continuous improvements in the financial accountability of Malaysian organizations.

Firstly, attention should be given to the existing staff. Since one of the factors is lack of accounting skills, workshops and seminars on accounting issues should be conducted for them. Previously, these seminars and workshops emphasised the theoretical input, but for this purpose, emphasis should be given on the practical aspects. Each participant should be encouraged to bring the most common problems that arise in the preparation of the financial statements. The purpose of such seminars is not to find fault but to share experiences. These seminars would provide exposure to participants in order to tackle the problems if they occur again. In addition, such seminars would help to update the knowledge of the accountants on the latest development in accounting issues.

Secondly, these organizations need to recruit new qualified staffs in order to overcome shortage and incompetence of staff. Proper training on local government accounting is vital for the new recruits to ensure that they are equipped with the necessary knowledge and skills. The management of organizations needs to continuously expose the staff to current accounting regulations.

Thirdly, the management should encourage their staff to fully utilize the computers in their daily routines especially in preparing financial statements. Clear instructions and simple computer manuals should be introduced to help their staff to gain confidence in using computers. In addition, computer classes and seminars should be held for all levels of staff to educate and update their skills and knowledge in computing. Consequently, the use of computers will help the staff to complete their tasks effectively and in shorter time, thereby generating faster and better financial statements.

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