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SAIGA

ADVANCING AUDITING AND ACCOUNTABILITY

The Southern African Journal of Accountability and Auditing Research

The Southern African Journal of Accountability and Auditing Research

REVIEWERS (continued)

Editorial

Herman de Jager - Editor

PRACTICES OF INTERNAL AUDITING IN SOUTH AFRICA

Lenz and Hahn (2015:6) argue that in today's complex business environment the internal auditing profession can "become either marginalised between a variety of other assurance, compliance and risk management functions or [it can] emerge as a recognised and stronger profession", while the Institute of Internal Auditors (IIA) regards the internal auditing profession as being at a crossroads (IIA 2009). In response to these challenging statements, the editorial board of *The Southern African Journal of Accountability and Auditing Research* have published this special edition containing reflections on current internal auditing practices in a developing country, specifically South Africa.

A call was made to part-time postgraduate students enrolled at the University of Pretoria, and particularly those with industry expertise, to share their internal audit research (as this has been strongly influenced by their real world practices), and, by following such a pragmatic approach, the ensuing research is reported on in the articles in this special edition.

Over the past six decades or so, the role of internal auditing has expanded from what was essentially a compliance-oriented service to a much broader, management-oriented service. The literature reports that an effective internal audit function has a positive impact on the organisation's corporate governance and control environment (Gramling, Maletta, Schneider, & Church 2004), its risk management (Sarens 2009; Carcello, Hermanson & Raghunandan 2005) and the quality of its financial reporting (Prawitt, Sharp & Wood 2012). Corporate governance at firm level is important for developing countries as it facilitates their access to financing, lowers the cost of capital and improves firms' operational performance (Claessens & Yurtoglu 2013; Peters, Miller & Kusyk 2011). South Africa, the first developing country to have introduced a nation-wide corporate governance code, is generally recognised for that progressive corporate governance code, and researchers have reported that the code's principles are practised to a gratifyingly high degree (Waweru 2014; Padayachee 2013; Ntim 2013). This code, which is now considered an essential corporate governance mechanism, provides an interesting context within which to reflect on the practice of internal auditing, the focus of this special edition (IoDSA 2009).

Extant literature on the practice of internal auditing in South Africa remains scant (De Jager 2014), and the twelve articles comprising this special edition make a notable contribution to remedying the dearth of published research. Collectively, these articles create a compelling case for internal auditors in a developing economy, but they also recognise that effective implementation of the function is not without challenges. These articles cover a wide sweep of the internal auditing sphere, including the roles and responsibilities of internal auditors; practices followed; public sector perspectives, and how internal audit functions should position themselves in companies with operations spanning international borders.

During the last five decades, the world has witnessed a dramatic proliferation of multinational companies that has evoked strong interest amongst academic researchers. Despite the acknowledged need to expand internal audit activities to cover the diversified operations of these companies, with their presences in multiple countries and subject to a plethora of legal, accounting and auditing regimes, only limited research has been performed from an internal auditing perspective. Drawing on institutional theory, the article by Shishkina and Barac reviews various international business management frameworks, in order to suggest an appropriate approach for the establishment and management of the internal audit functions of multinational companies. The argument is presented that geocentricity (which implies careful customisation of standard business processes to address local context, while operating within established, uniform norms) seems to be an appropriate approach for the organisation of the internal audit function of a multinational company.

In considering the roles and responsibilities of internal auditors, Forte and Barac provide insight into the interrelationships between the features of enterprise risk management (a well-researched field), and the combined assurance processes (an as yet under-researched field, with limited published research). By conducting a survey soliciting the views of chief audit executives within the private sector, the study found that there appears to be a dependency on the enterprise risk management (ERM) process; that is, an established ERM process appears to be a prerequisite for the implementation of a combined assurance process.

Building on the roles and responsibilities of internal auditors in relation to risk management, Viljoen and Barac's article explores internal auditors' involvement in consulting and risk assurance activities within South Africa's private sector organisations, and examines how internal auditors identify and evaluate risks within organisations. Survey results indicate that internal auditors have an extensive level of involvement in providing assurance on risk functions, a moderate level of involvement in providing consulting activities, and only a limited level of involvement in risk management roles, and that these roles differ according to industries. Internal auditors utilise various sources of information, and employ a diverse array of qualitative and quantitative constructs when identifying risks and considering their impact.

Looking at internal auditing's role in risk management through a more narrowly focused lens, the article by Whitehorn and Barac focuses on the South African mining sector, which is currently in turmoil and facing risks that can prevent the entire sector from meeting its objectives: these risks are both expected and unexpected, and even include 'black swans'. This research found that internal auditing was performing "in line with expectations", but that the function must in future play a bigger role in the determination of the organisation's strategic direction by challenging its currently employed risk identification criteria and risk assumptions, in order to focus on sustainability. This requires that internal auditors enhance their technical skills to include understanding of the operational risks specific to mining.

In his article, Lingenfelder continue with the theme of industry-specific analyses, by offering insights into the involvement of internal audit functions with financial modelling in the banking sector. It is common knowledge that it was faulty or improper use of models that contributed significantly to the adverse financial situations and negative reputations experience by banking institutions in the aftermath of the global financial crises. Regulators have become increasingly concerned about the soundness of banks' decision-making capabilities, and the capital requirements they derive from their models. The author argue that internal audit functions should be capable of providing assurance and auditing services to such areas of the banking industry. His study investigated the broadening of the internal audit function's ambit to include robust coverage of risks posed by indiscriminate use of current financial and risk models within banking institutions. His conclusions on the state of risk management (both as an embedded function, and as an ad hoc service), internal audit's coverage of model risk, and the skills that internal audit needs in order to render appropriate services in this arena led to a set of recommendations on how internal audit functions should enhance their approach to and coverage of model risk.

Peter and Steyn present the first South African study on the use of share incentive schemes for the head of internal audit or chief audit executives, They argue that the use of share incentive schemes as part of the remuneration structure for the chief audit executive is one mechanism a company can use to incentivise its senior executives and ensure they manage the company to add value. This can lead to challenges as internal auditors have always had the task of playing two contradictory roles: being an employee in a company and being an objective person involved in rendering independent assurance services for the company. Care must, therefore be taken to ensure the share incentives do not have a negative influence on the level or perceived level of independence and objectivity of the chief audit executive, By using structured interviews in a multiple case study the views of the chairpersons of audit committees on the use of share incentive schemes for the chief audit executives were obtained. The study found that share incentive schemes were mostly used to incentivise chief audit executives and were deemed to be an acceptable remuneration mechanism.

Three articles in this special edition comment on practices currently being followed by internal auditors. In that Transparency International (2014) ranked South Africa at position 67 out of a 175 countries and territories surveyed, and that its score of 44 indicates the public sector is on the corrupt end of the scale (where 0 = highly corrupt, and 100 = very clean), it is not surprising that two of these articles consider matters of an ethical nature. Appel and Plant conducted a literature review and identified attributes they included in a framework that can be used by the internal audit function to assess the degree of ethical behaviour in the cultures of South African national government departments. The limited number of published articles on the use of ethics frameworks in government, especially in the South African context, indicated a need for such a framework. In their study, they held follow-up discussions with three interviewees from one national department, and it appears that an ethics framework could positively assist the internal audit function in assessing an organisation's ethical culture, and help management to enhance the organisation's ethical health.

Kgomo and Plant's article examines the notion of monitoring the effectiveness of organisations' promotion of ethical leadership, which they regard as challenging for internal auditors. Although attempts have been made to provide internal auditors with guidelines on how to assess the tone-at-the-top, these efforts are still largely compliance-based, an approach that continues to fall short of expectations when applied to questions of ethics. Their study proposes additional dimensions to those contained in the Integrated Control Framework prepared by The Committee of Sponsoring Organisations of the Treadway Commission (COSO), to achieve a value-based approach to the assessment of ethical leadership.

Padayachee and De Jager present the view that performing an integrated audit engagement is simply good audit practice. An integrated audit approach entails an intentional audit design process that cohesively combines business process auditing and information technology auditing into a single, co-ordinated effort. In their article, Padayachee and De Jager argue that the internal auditing fraternity has been slow to evolve, inhibited by longstanding preferences for traditional methods of performing audits, which has resulted in the neglect of training programmes that would result in internal auditors who are confidently able to perform integrated audits. Their study found that although holders of the Certified Internal Auditor (CIA) qualification, and other members of the IIA, are perceived to have mastered the theoretical knowledge provided by the CIA certification programme and other training courses, the manner in which they perform audit engagements does not demonstrate the sound and practical application of this knowledge.

A recurrent theme in the last three articles, presented from a public sector perspective, is the nature and extent of the challenges experienced by public sector entities from an internal auditing perspective. In their article, Radasi and Barac focus on state-owned enterprises, and report the perceptions of, expectations for and challenges experienced by their internal audit functions. By following a qualitative research approach, the study reveals that although internal audit functions are perceived in a positive light, and while participants in the research place much reliance on internal audit, internal audit functions still face a myriad of challenges. These include a lack of performance auditing in state-owned enterprises; the differences between methodologies and auditing systems used by outsourced functions; the frequency of repeat findings; a lack of business knowledge and insight; unfamiliarity with or absence of combined assurance, and non-compliance with quality assurance and improvement standards.

Turning the focus to the local government sector Marias questions whether or not internal auditors employed in local government understand the IIA's requirements regarding objectivity, and how they perceive and manage their own objectivity. The results show that the majority of internal auditors surveyed do understand the concept, and do realise its importance. Furthermore, perceiving that compromising their objectivity can impact their own effectiveness and that of their internal audit units, they take steps to manage and protect it.

Ramusheli and Janse van Rensburg make the argument that the achievement of public sector service delivery objectives is crucial for a developing country such as South Africa, as the public depends on local government organisations to deliver mostly essential services (the key services being water, electricity, sewerage, and roads). By performing a literature review and a content analysis of public sector audit reports, their study identifies the root causes of municipalities' failure to deliver efficiently and effectively the services they are mandated to deliver. These causes include: inadequate human resource capacity; shortage of skills; unethical organisational culture, and ineffective (or non-existent) performance management systems. They ascribe these to two all-pervading factors, namely a lack (or absence) of leadership commitment, and a management system that is almost completely devoid of consequences for poor performance and wrong-doing.

It is hoped that the insights included in these research articles will inform readers, and will inspire and guide those in the business of internal audit and audit management to address the problems identified, and to make use of the tools and possibly new ideas presented here.

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Managing risk: What should internal audit do?

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ABSTRACT

Internal auditors, having the required knowledge of risk management, organisational processes and internal controls systems, could perform a number of activities for the organisation in order to assist in managing risks. The Institute of Internal Auditors provides guidance to internal auditors indicating their related roles. Previous studies (which do not include a South African perspective) suggest that internal auditors' involvement in these roles tend to differ between countries and could change over time. Additionally, while a key role for internal auditors is to identify and evaluate risks within an organisation, little guidance is provided as to how internal auditors should achieve this. This article explores internal auditors' involvement in consulting and assurance activities within South African private sector organisations, and secondly, how internal auditors identify and evaluate risks within organisations. Data was collected by means of an online survey instrument, directed at chief audit executives. Survey results indicated that internal auditors have a large degree of involvement in providing assurance on risk functions, a moderate degree of involvement in providing consulting activities and a limited degree of involvement in risk management roles. Internal auditors utilise previous experience and various external sources of information, when identifying risks, and consider risk impact in both a qualitative and quantitative manner. Statistical analysis reveals that the internal auditors' degree of involvement in the various roles differs in the manufacturing and financial services sectors.

Key words

Internal audit profession; internal audit roles; internal audit function; risk assurance; risk consulting; managing risk; enterprise risk management; risk identification; risk evaluation

1 INTRODUCTION

The business world is constantly changing, which continually exposes organisations to new risks (COSO 2009:2; Jie 2012:287; PwC 2008:3). Risk events could result from internal control failures, unexpected external events, ethical lapses, poor decision-making, and natural world catastrophes and crises (Culp, Faris & Pulp 2011:2; Edmead 2007; Gramling & Hermanson 2009:39; Mitroff & Alpaslan 2003:10). In the recent past the impact of unanticipated risk has been illustrated by the occurrence of major accounting frauds (Enron, Tyco, Parmalat and Worldcom being amongst the most dramatic singular events) (Carey, Subramaniam & Ching 2006:12; Gramling & Hermanson 2009:39; Mardjono 2005: 272), and the global financial crisis of 2007 – 2009 that resulted in bank bailouts and recession (Kumar & Singh 2013:21; Shortreed, Fraser, Purdy & Schanfield n.d.:1). Recent events in South Africa have also focused attention on risk issues: for example, the recent strikes in the mining and metal sectors (Allix 2014), and the collapse of African Bank (Smith 2014).

Risk assessment is an educated view of the possibility that an event will occur that will negatively impact the achievement of an organisation's objectives (IIA 2013a:22). To manage risk effectively and efficiently, and to achieve their objectives, organisations need to be well prepared (Boyle & Boyle 2013:5; Mitroff & Alpaslan 2003:6; Payne 2002:21). The concept of risk in general, and the specific risks threatening an organisation (e.g., information technology risks, financial risks, compliance risks, strategic risks and external risks), should be understood by management (Edmead 2007; IoD 2009:73). Addressing these issues should form part of a risk management framework designed specifically to mitigate the business' key risks (IoD 2009:73). The board and senior management, who are ultimately responsible for risk management (COSO 2004:4; COSO 2009:4-5; Fraser & Henry 2007:406; Goodwin-Stewart & Kent 2006:83; IIA 2013a:62; IoD 2009:73; Payne 2002:21; Sarens & De Beelde 2006a:238), need to develop the organisation's risk response processes and strategies (ranging from risk avoidance, through risk mitigation, to risk transfer and ultimately risk acceptance) (COSO 2004:4; COSO 2009:2-3; Department of National Treasury 2014; Jaques 2007:151; Project Management Institute 2000:3; Shortreed *et al* n.d.:5; Spira & Page 2003:644). Collectively, these processes are often described as the organisation's enterprise risk management (ERM) process, which is defined as a process utilised throughout the organisation, applied during strategy setting, and influenced by various stakeholders (i.e., the board of directors, management, and other personnel) (COSO 2004:4; COSO 2009:4). ERM is designed to provide reasonable assurance regarding the achievement of an entity's objectives by identifying potential events that may impact the organisation, and from this to manage risk so that it falls within the risk appetite of the organisation (COSO 2004:4; COSO 2009:4).

The literature supports the notion that internal auditors' knowledge about risk management techniques, organisational processes, and internal control systems enables them to play an important role within these spheres of an organisation (Carey *et al* 2006:22; Coetzee & Lubbe 2011:31; Sarens & De Beelde 2006:66; Fraser & Henry 2007:393; Wagner 2002:3). This is in line with the Institute of Internal Auditors' (IIA) definition of the internal auditing function as "...a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes" (Gramling & Hermanson 2009:39; IIA 2012). Against this background, the question remains - what is the internal auditor's role in managing risk within an organisation?

Over the past decade, many attempts have been made to answer this question. A position paper issued by the IIA identified the various ERM roles that internal audit *should* perform, and equally, those it should not perform. In addition, the IIA identified those ERM roles internal audit *could* perform, subject to certain safeguards having been put in place (IIA 2004; IIA 2009a). In a study performed by the IIA in 2010, and a similar one conducted by PricewaterhouseCoopers (PwC) in 2011, the vast majority of chief audit executives (CAEs) interviewed (80% of respondents in the case of the former and 79% in the case of the latter), agreed that internal audit activities relating to ERM were going to increase, and it was anticipated that risk management would soon become one of the cornerstones of the internal audit function (IAF) (Boyle & Boyle 2013:3; PwC 2011). Previous studies supported this forecast; however, they also identified some differences in the roles internal auditors were likely to be performing regarding ERM (De Zwaan, Steward & Subramaniam 2011; Gramling & Myers 2006; Sobel 2011). These studies established that between countries there were differences in the ERM roles internal auditors were performing, and that roles were changing rapidly (De Zwaan *et al.* 2011; Gramling & Myers 2006; Sobel 2011:11). In addition, the role of internal auditors in relation to risk assurance and consulting within South African organisations was, and remains, unexplored. This leads to the first objective of this study, which is to determine the nature and extent of the risk assurance and consulting roles internal auditors perform within South African organisations.

The second objective of this study is to determine how internal auditors identify and evaluate risks, the tasks which have been identified as key internal audit responsibilities (IIA 2012:11). Recent studies, including the 2010 IIA GAIN Flash survey (66% positive response) and a 2013 PwC Survey (positive responses from 85% of senior management, 90% of board members, and 96% of CAEs), indicated that internal auditors should identify and evaluate key risks (PwC 2014:8; Sobel 2011:11). Although earlier studies indicated that the identification and evaluation of risks are key responsibilities for internal auditors, they nevertheless provide little guidance on how internal auditors should go about fulfilling these responsibilities. Attempting to identify the "how" addresses the second objective of this study.

The remainder of this study is organised as follows. In the next section a literature review positions the study within in the existing body of knowledge. Subsequent sections describe the research method and the results of the study, and in the final section conclusions are reached and suggestions are made for future research.

2 LITERATURE REVIEW

Internal auditors are academically and professionally equipped to perform various functions relating to risk (Gramling & Myers 2006:52; IIA 2009a:6; Sobel 2011:11-13). However, before fulfilling these functions, issues of good corporate governance require that safeguards are put in place to maintain the objectivity and independence of the IAF (Gramling & Myers 2006:52; IIA 2009a:6; Sobel 2011:11-13). Internal auditors are ideally positioned to assist management in managing risk efficiently and effectively (Carey *et al* 2006:22; Coetzee & Lubbe 2011:30; Sarens & De Beelde 2006a:220). However, their role is practically defined by the audit committee and senior/executive management (Payne 2002:21; Sobel 2011:8; Tusek & Pokrovac 2010:2-3), so until the support and co-operation of the board and senior/executive management is obtained, they cannot optimally fulfil their obligations (Payne 2002:21; Schneider, Sheikh & Simione 2011:29).

The IAF's role is influenced by factors that include the competencies of its individual internal auditors (especially their communication skills) (Boyle & Boyle 2013:7; Fraser & Henry 2007:396), a supportive (or otherwise) organisational culture, and management's awareness of how internal audit could provide consulting and/or assurance services (Sobel 2011:8; Tusek & Pokrovac 2010:2-3). In addition, internal auditors are expected to demonstrate a deep understanding of the business and to employ risk analysis and control assessment techniques, together with soft (interpersonal) skills (Boyle & Boyle 2013:7; Fraser & Henry 2007:396). The IIA states that internal auditors should perform their responsibilities with proficiency and due professional care (IIA 2012:6), which is achievable with appropriate training and experience in risk management (Edmead 2007), an understanding of the risks threatening the success of the organisation, and an overall understanding of how the organisation operates (Coetzee & Lubbe 2011: 30).

Against this background, the literature supports the contention that internal auditors could perform a variety of functions relating to risk, and identifies two main areas: providing assurance and consulting on risk management (the latter including the identification and evaluation of risks). An overview of the literature is presented next.

2.1 Internal audit's assurance and consulting roles in risk management

Internal auditors could play a valuable role in providing ongoing assurance and consulting activities on ERM (Hall 2007:11; KPMG 2008). This is due to their knowledge of an organisation's risk universe, their knowledge of risk-based assessments, and their relationship with executive management; in addition they have an ability to analyse large amounts of information and to deliver clear and concise findings (Hall 2007:11; KPMG 2008). However, internal auditors, management, and boards struggle to find an appropriate balance between internal audit's two roles: consulting and assurance (De Zwaan *et al* 2011:600). The IIA has therefore provided guidance by dividing internal audit's roles in ERM into three sections: internal audit's **core** roles, **legitimate** internal audit roles, and roles internal audit should **not** undertake (2009a:4; 2004:1-2).

These roles have been evaluated through various surveys (De Zwaan *et al* 2011; Gramling & Myers 2006; Sobel 2011:10), with the general consensus being that internal auditors' risk assurance and consulting roles continue to vary across socio-economic regimes and over time, which is appropriate, given the evolutionary nature of regulatory and statutory frameworks.

2.1.1 Internal audit's core roles

Internal audit's core roles relate to its assurance activities, and include providing assurance on risk management processes, determining whether risks are correctly evaluated, evaluating risk management processes, evaluating the reporting of key risks, and reviewing the management of key risks (IIA 2009a:4; IIA 2004:1-2; Sobel & Reding 2004:33).

Surveys performed in 2005 (Gramling & Myers 2006) and 2007 (De Zwaan *et al* 2011) indicate that internal auditors accepted "moderate" assurance responsibilities for risk management processes and for whether risks were correctly evaluated. In addition, these surveys indicate that these responsibilities increased in the period 2005 to 2007 (Gramling & Myers 2006; De Zwaan *et al* 2011). This increase could show a growing awareness at the level of management and boards of directors of the internal auditor's role in risk management (De Zwaan *et al* 2011:599). These surveys (De Zwaan *et al* 2011; Gramling & Myers 2006) further indicate that internal auditors have accepted as theirs, the responsibility for evaluating the reporting of key risks and reviewing the management of key risks (De Zwaan *et al* 2011; Gramling & Myers 2006).

The 2009 survey conducted by Sobel (2011:10) provides some contrasting views. Sobel's results indicate that most responding internal auditors were not providing assurance on risk management processes and, although internal auditors were aware of their assurance responsibilities in relation to risk management, they had not fully embraced them (Sobel 2011:10). Chambers (2014:213) supports the notion that internal auditors could perform more assurance work on behalf of the board. In addition, Sobel (2011:10) believes that CAEs should be more proactive in obtaining and developing the right skills within the IAF in order to fulfil these responsibilities more effectively and efficiently.

2.1.2 Internal audit's legitimate roles

Internal audit's legitimate roles are additional roles that relate to consulting activities which could be performed by internal auditors, provided that the necessary safeguards to their independence are in place (IIA 2009a:4; IIA 2004:1-2). Such activities frequently include facilitating the identification and evaluation of risks, participating in the identification of emerging risks, coaching management on risk response, providing consulting reports to facilitate or improve the implementation of the risk management processes, and compiling consolidated reports on risks (IIA 2009a:4; IIA 2004:1-2).

Results of the 2005 survey (Gramling & Myers 2006) and the 2007 survey (De Zwaan *et al* 2011) indicate that internal auditors' participation in these legitimate roles was declining, and that internal auditors only accepted "limited" to just more than "moderate" responsibility (on the survey instruments' response scales) for their output in this regard. These findings were supported by a 2009 survey (Sobel 2011) that indicated the potential for internal auditors to extend their consulting roles in relation to risk management in both number and depth of analyses provided (Sobel 2011:11). This could contribute towards the improvement of an organisation's governance, risk management and control processes (IIA 2009a:4-5). An IAF's involvement in such consulting roles may vary over time, and depends on its resources and the risk maturity of the organisation (IIA 2009a:5). Ultimately, the appropriate balance between the independence of the IAF and the extent to which it provides consulting services to the organisation must be decided by the entity's board and audit committee (Payne 2002:21).

2.1.3 Roles internal auditors should not perform

The roles identified under this heading relate to management functions, the performance of which would impair the internal auditor's objectivity (IIA 2009a:4; IIA 2004:2). They include setting the risk appetite for the organisation, taking decisions on risk responses, implementing risk responses on management's behalf, accepting accountability for risk management processes, and participating in the setting of organisational policies for risk management processes (De Zwaan *et al* 2011; Gramling & Myers 2006; IIA 2009a:4; IIA 2004:2; Sobel 2011:11; Sobel & Reding 2004:33). The results of the 2005, 2007 and 2009 surveys discussed above support the notion that internal auditors should not take part in these activities, as was evidenced in the small number of respondents who indicated acceptance of these responsibilities (De Zwaan *et al* 2011; Gramling & Myers 2006; Sobel 2011:11). Despite the small number of IAFs that acknowledged taking part in these activities or providing these services, it is still concerning that some IAFs are prepared to compromise their objectivity by performing these management functions (De Zwaan *et al* 2011:599).

2.2 Internal audit's role in risk identification and evaluation

The literature supports the view that, based on their training and experience, internal auditors could assist the organisation in identifying various risks (current and emerging), as well as in defining their potential effects (Chambers 2011; Gramling & Hermanson 2009:41; O'Reilly-Allen & Mawn 2011:31; PwC 2008: 9; Sobel 2011:10). Internal auditors could assist the board and senior management in identifying the various risks faced by the organisation through a review of its own prior incidents, and by preparing an analysis of the threats facing the business environment which could impact the organisation itself or its operating environment (Carey *et al* 2006: 12; O'Reilly-Allen & Mawn 2011:32; PwC 2008:9).

Chambers (2011) believes that having an attentive IAF, which follows a proactive approach to identifying and proposing responses to risks, could assist organisations to work through tough periods, thus ensuring the achievement of organisations' objectives. To achieve this level of functional excellence, internal auditors should identify the risks within each activity or process under review, by considering the risk assessments performed as part of the risk management process, or by performing their own risk assessments which should include the identification and evaluation of risks (IIA 2013a:74). Additionally, internal auditors could identify risks by reviewing internal and external processes, the reports of the entity's internal and external assurance providers, and other pertinent information (Fraser & Henry 2007:393; IIA 2013a:37; Payne 2002:21). In doing so the IAF acts in conformance with Standards 2200, 2201 and 2210.A1, which require that, when planning an internal audit engagement, the internal auditor should consider the risks that could impact not only the process being audited, but the organisation as a whole (IIA 2012:13). The IAF should focus on the significant risks, those risks with the highest likelihood of occurring, and on those likely to have the highest impact on the activity under review; however, this should not be done at the expense of providing coverage of other, more mundane, risks as well (Deloitte 2012:2; Edmead 2007; IIA 2012:13).

In addition to identifying the risks faced by the organisation, internal auditors should re-evaluate already identified risks (operational, strategic, compliance, financial, and sustainability risks) (IoD 2009:94-94). This should be done by assessing the impact and likelihood of these identified risks, and by considering the mitigating steps (risk response strategies) taken by the organisation to manage such risks (Chambers 2011; Edmead 2007; Gramling & Hermanson 2009:41; O'Reilly-Allen & Mawn 2011:31). In addition, internal auditors are expected to evaluate existing risk response strategies to determine the effectiveness thereof, and to report on such weaknesses they might find within these processes (IIA 2009a:10-12; Martin 2013:26; Sarens & De Beelde. 2006:66; Shortreed *et al* n.d.:5; Tusek & Pokrovac 2010:2-3).

Internal auditors achieve the objectives detailed above by focussing their internal audit plans on risks (specifically the most significant risks) (IIA 2013a:69), while also providing coverage of lower level risks by prioritising those risks which have not yet been subject to an internal audit (IIA 2013a:41). Internal auditors, through testing, provide assurance that internal controls are adequate and effective, and that plans are detailed yet flexible enough to accommodate various risks which may impact on the organisation (Chambers 2011; Edmead 2007; Gramling & Hermanson 2009:41; O'Reilly-Allen & Mawn 2011:31). Internal auditors should consider both the risk's quantitative impact (e.g. financial impact) and its qualitative impact (e.g. reputational damage), and the likelihood of the risk event occurring throughout the organisation (Edmead 2007; PwC 2008:7). This conforms with the requirements of Practice Advisory 2200-2, which emphasises that internal audit should identify the key controls mitigating significant risks that could impact the organisation as a whole, and not only focus on the impact of the risks specific to the activity under review (IIA 2013a:71).

Practise advisory 2010-2 (IIA 2013a:39) does however acknowledge that internal auditors may not be qualified to assess every risk within an organization. In these instances the CAE should ensure that those internal auditors with the required expertise are utilised or, if such are not available within the organisation, then external service providers should be used (IIA 2013a:39; IIA 2013b:5; IIA 2009b:3).

In order to evaluate this, and the different roles internal audit performs in managing risk, an online survey was conducted and will be discussed in detail within the next section.

3 RESEARCH METHOD

In an attempt to determine the nature and extent of South African internal auditors' risk assurance and consulting roles in managing risk, and in order to determine how internal auditors go about identifying and evaluating these risks, a quantitative research approach was adopted. An online survey was used to provide a quantitative description of opinions of the population (CAEs in the South African private sector) by studying a sample of that population (Creswell 2014:13). Empirical data was obtained through a self-administered questionnaire (Sekeran & Bougie 2013: 102).

Based on previous research instruments described in the literature, a questionnaire was designed for online use. The online survey tool Survey Monkey [www.surveymonkey.com] was used in this endeavour. The survey was pilot tested by the CAE of a listed private sector organisation. CAEs were specifically targeted because they are ideally positioned within organisations to comment on both the risk assurance and consulting roles fulfilled by their IAFs, and the risk identification and evaluation processes followed within their IAFs (Burnaby 2012:27; Van Staden & Steyn 2009:919). Judgemental or purposive sampling was used; thus the sample is not statistically representative of the research universe, and the results therefore cannot be deemed generally applicable (Briggs & Coleman 2007:135; Teddlie & Yu, 2007:77). The survey was sent out in two phases. Firstly, 27 CAEs were individually invited to participate in the study via emails sent out between the 16th of February 2015 and the 12th of March 2015. The CAEs' personalised emails included an explanation of the purpose of the study. The letter confirming the study's ethical clearance was sent as an attachment to the email. In order to augment the response, a second series of emails was sent to the Institute of Internal Auditors South Africa's (IIASA's) database of members. The IIASA sent this bulk email invitation on the 12th of March 2015 to all members, requesting CAEs within the private sector to respond by 30th of March 2015. The bulk email also included an explanation of the purpose of the study, a link to the online survey and the ethical clearance letter.

The survey was designed to obtain the views of CAEs, Acting CAEs, and heads of internal audit departments within private sector organisations within South Africa. The study was limited to the private sector because prior research, conducted by Coetzee and Lubbe (2011:54), indicated that private sector organisations in South Africa have reached higher levels of risk maturity than those in the public sector. The online survey approach was designed to provide respondents with anonymity, as this generally results in more accurate and honest responses to the questions (Meretsky 2013:66). Finally, the covering email addressed several ethical issues (Sekeran & Bougie 2013:162). Respondents were assured that their information would remain confidential, that ethical clearance for the research had been obtained from the University of Pretoria, and that respondents were under no obligation to participate in the study.

The survey consisted of 21 questions. Questions 1 to 3 requested the respondent to provide personal profile information, while the remaining questions related to the objectives of the study. A five point Likert scale was used and respondents selected an appropriate point on that scale to reflect their response to the questions.

A total of 40 responses were received from CAEs within the South African private sector. The IIASA's database only has 640 private sector CAEs registered as members in South Africa (Brazao 2015). The resulting response rate is therefore 6.25%, which is in line with the low response rate generally associated with web surveys (Fan & Yan 2010:132). The relatively low response rate and the judgemental and purposive sampling are limitations which need to be considered when evaluating the results of the study. The survey responses were obtained from CAEs across various industries. A breakdown of responses by industry shows that the majority of respondents were from financial services organisations (27.5%), manufacturing (15%), consulting (10%), retail (7.5%) and mining (7.5%). In addition, the majority of responses were received from CAEs employed by companies listed either on the Johannesburg Stock Exchange (62.5%), and/or other securities exchanges (7.5%). Only 32.5% of respondents indicated that their organisations were not listed. Additionally, the majority of responses were obtained from experienced CAEs, with 32.5% indicating that they had more than 10 years' experience, 22.5% between seven and nine years' experience, 17.5% between three and six years' experience, and only 27.5% reporting that they had less than three years' experience as CAE.

4 RESULTS

The results are presented and discussed according to the themes identified in the literature that informed the objectives of the study. These discussions are based on a statistical analysis of the data. Descriptive statistics are provided for all themes where significant inferential statistics are provided.

4.1 Internal audit assurance and consulting roles in risk management

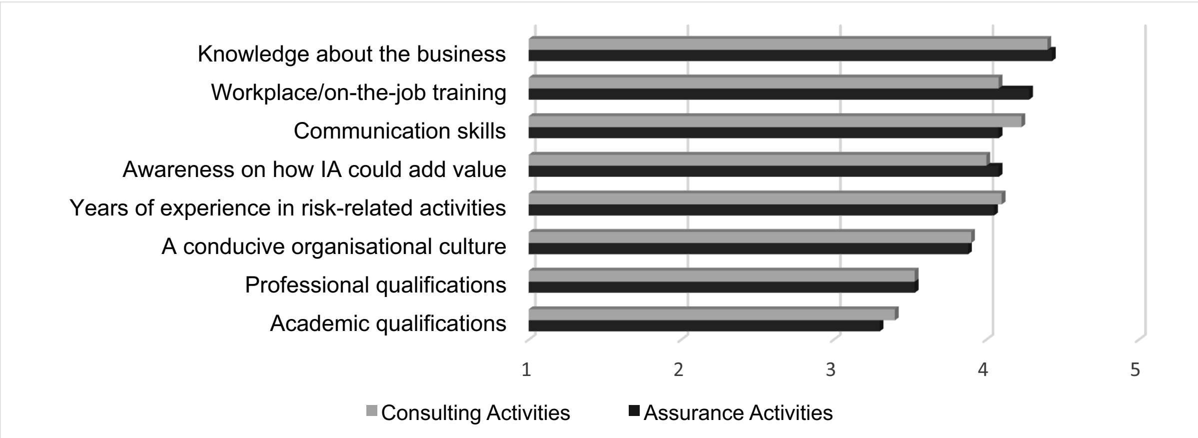
4.1.1 Influencing factors

Respondents were requested to indicate their level of agreement with three statements about the knowledge needed by internal auditors in order to play a significant role in risk management within an organisation. Responding CAEs strongly agreed (where the mean <1.5 = no agreement, 1.5 to 2.49 = little agreement, 2.5 to 3.49 = moderate agreement, 3.5 to 4.5 = agreement, and >4.5 = strong agreement), that internal auditors' knowledge about organisational processes (mean = 4.85) and internal control systems (mean = 4.88) enabled them to play a significant role in managing risk within an organisation. They did however indicate a lower level of agreement with the statement that internal auditors' knowledge about risk management techniques (mean = 4.45) enables them to play a significant role in managing risk within an organisation. Responding CAEs also agreed that internal audit's role in managing risk is largely defined by the audit committee (mean = 4.20), while a lower level of agreement was evident for senior and executive management (mean = 3.73). This could be because CAEs believe that too much involvement (interference) from management on the internal auditors' role in managing risk within an organisation could affect the IAF's objectivity.

In order to determine internal audit's perceived competence to provide assurance and fulfil consulting roles in risk management, CAEs were requested to indicate their level of agreement on four statements regarding the competence and experience of their internal auditors. Responding CAEs indicated that for risk related consulting, their IAFs were both competent (mean = 3.9) and sufficiently experienced (mean = 3.8). For assurance the mean for competence was 4.08 and the mean for experience was 4.0. Additionally, inferential statistics were used to determine the statistical significance and strength of the relationship within the group of CAEs that believed their IAFs were competent to provide both risk assurance and consulting services. Spearman's Rho rank-order correlation coefficients were used as the variables, as these are ordinal scaled, to evaluate the strength and statistical significance of the relationship (Myers & Well 2003:508). The relationship between CAEs indicating that their IAFs are competent to provide risk related assurance activities and to provide risk related consulting services was positive, of moderate strength, and statistically significant at the 1% level of significance (p=0.000, p>0.01).

Respondents were requested to indicate on a five point Likert scale the extent of the influence which each of eight factors that could influence the IAF's involvement in risk related consulting and in assurance activities had on these activities. Responding CAEs agreed that an internal auditor's knowledge about the business had the most influence on both their ability to provide assurance and to perform consulting activities. This was followed by internal auditors' communication skills. It was also evident that internal auditors' knowledge about the business, their workplace/on-the-job training, and management's awareness of how they could add value, have a greater influence on the internal auditors' role in providing assurance services than it does on their role in providing risk related consulting services. By contrast, internal auditors' communication skills and their years of experience in risk related activities have greater influence on their involvement in risk related consulting activities than on their provision of assurance activities.

Figure 1: Factors influencing the IAF's involvement in risk related consulting and assurance activities



(<1.5 = no influence, 1.5 to 2.49 = little influence, 2.5 to 3.49 = moderate influence, 3.5 to 4.5 = large influence, >4.5 = very large influence)

Considering Figure 1 in the context of the responding CAEs agreement that their IAFs understand how the organisation operates (mean = 4.20) and their IAFs understand the risks threatening the organisation (mean = 4.30), it could be argued that IAFs in general are well positioned to provide consulting and assurance activities to assist the organisation in managing risk.

Due to the small sample size and ordinally scaled data, the Mann-Whitney nonparametric test was used to test whether financial services organisations differ from manufacturing organisations with regard to how the various factors in Figure 1 influence internal auditors' involvement in performing risk related consulting and assurance activities (Aaker, Kumar & Day 2007:445). The results of this test indicated that statistically significant differences exist at both the 5% and 10% levels of significance between the two types of organisations. At a 5% level of significance the results indicated that internal auditors' academic qualifications (p=0.023, p<0.05) had a greater influence on their involvement in risk assurance activities within financial services organisations (mean rank is 10.91) than within manufacturing organisations (mean rank is 5.50). Additionally, at a 10% level of significance, responding CAEs indicated that management's awareness of how internal audit could add value (p=0.06, p<0.1) and internal auditors' workplace/on-the-job training (p=0.79, p<0.1) had a greater influence on internal audit's degree of involvement in risk assurance activities within financial service organisations (mean ranks amounted to 10.55 and 10.45 respectively) than within manufacturing organisations (mean ranks amounted to 6.17 and 6.33 respectively).

Using the Mann Whitney nonparametric test at a 10% level of significance, results indicated that internal auditors' communications skills (p=0.62, p<0.1) influenced their role in providing risk-related consulting activities to a greater extent within manufacturing organisations (mean rank is 11.92) than within financial services organisations (mean rank is 7.41).

It could therefore be concluded that the IAF's involvement in providing risk assurance and consulting activities is dependent on the industry within which an organisation operates, and is affected by internal auditors' academic qualifications, management's awareness of how internal audit could add value, the extent of their on-the-job training, and their communication skills.

4.1.2 Internal audit risk management core roles

The literature supports the notion that the IAF's core risk management roles relate mostly to risk assurance activities (De Zwaan *et al* 2011; Gramling & Myers 2006; IIA 2009a:4; IIA 2004:1-2; Sobel 2011:10). Respondents were requested to indicate their IAFs' level of involvement in fulfilling core risk management roles. Respondents indicated that on average their internal auditors currently have a large degree of involvement in providing assurance on risk management processes (mean = 3.63); providing assurance that risks are adequately evaluated (mean = 3.50); evaluating risk management processes (mean = 3.53); evaluating the reporting on key risks (mean = 3.50), and on reviewing the management of key risks (mean = 3.78) (where the mean <1.5 = no involvement, 1.5 to 2.49 = little involvement, 2.5 to 3.49 = moderate involvement, 3.5 to 4.5 = large involvement, and >4.5 = very large involvement). These levels are higher than those indicated in previous research, in which only a moderate involvement by IAFs in performing these activities was recorded (De Zwaan *et al* 2011; Gramling & Myers 2006). The difference in findings could be explained by considering that these are core roles for IAFs, and the fact that CAE respondents agreed that internal auditors do have the required skills (experience, competence and knowledge of the business) to provide assurance on risk related activities (refer to section 4.1.1). Future research could however investigate the possibility of increasing internal audit involvement, to enable them to maximise the level of assurance they provide to their employer organisations.

The Mann-Whitney nonparametric test indicated that statistically significant differences exist at a 5% level of significance between internal auditors within financial services organisations (mean rank is 10.73) (who are more involved in providing assurance that risks are adequately evaluated ($p=0.044$, $p<0.05$)), than within manufacturing organisations (mean rank is 5.83).

4.1.3 Legitimacy of Internal audit's risk management roles

The literature supports the notion that the IAF's legitimate roles relate to risk consulting activities, noting that these should only be performed when adequate safeguards have been put in place to maintain internal auditors' objectivity (De Zwaan *et al* 2011; Gramling & Myers 2006; IIA 2009a:4; IIA 2004:1-2; Sobel 2011:10). Respondents were requested to indicate, on a five point Likert scale (as explained in 4.1.2), their IAF's level of involvement in the IAF's legitimate roles. Survey results, as expected, indicated that internal auditors currently have a moderate degree of involvement in providing consulting related activities. These are broken down as follows: facilitating the identification (mean = 3.33) and evaluation (mean = 3.48) of risks; coaching management in responding to risks (mean = 3.15); coordinating ERM activities (mean = 2.88); consolidating the reporting on risks (mean = 3.18); championing the establishment of ERM (mean = 3.03), and developing a risk management strategy for board approval (mean = 2.93).

The Mann-Whitney nonparametric test indicated that statistically significant differences exist at a 10% level of significance ($p=0.096$, $p<0.1$) between the involvement of internal auditors within financial services organisations (mean rank is 10.45) in facilitating the identification of risks than that of their counterparts within manufacturing organisations (mean rank is 6.33). This could indicate that IAFs in organisations within specific sectors could be ill-equipped to facilitate the identification of risks as a consulting activity. For the financial services sector, an industry which uses internal audit as part of their commitment to risk management (Goodwin-Stewart & Kent 2006:83, 91), a high degree of involvement was indicated by responding CAEs, as expected.

4.1.4 Risk management roles internal auditors should not perform

This study's survey results support previous research in that its respondents indicate that internal auditors should not take part in the activities discussed below (De Zwaan *et al* 2011; Gramling & Myers 2006; IIA 2009a:4; IIA 2004:1-2; Sobel 2011:10). Responding CAEs indicate that their IAFs have little involvement in setting the risk appetite for the organisation (mean = 1.98); implementing risk management processes (mean = 2.33); taking decisions on appropriate responses to risks (mean = 1.90); implementing risk responses on management's behalf (mean = 1.70), and assuming accountability for risk management (mean = 1.53). As these represent management functions, and the IAF's participation could affect the function's objectivity, such low levels of involvement are understandable. It remains a concern however, that some CAE respondents indicated a "moderate" to "very large" involvement by their IAFs in these activities. The management activity performed most often by these IAFs was implementing risk management processes (22.5% indicated moderate involvement, 17% large involvement, and 5% very large involvement). This could be due to organisations not yet having separate risk management functions, or organisations not having sufficient experience and/or resources to separate the management of the risk function from the IAF. While this is in itself a risk, it is probably preferable to have internal auditors perform these activities than to see these activities not being performed at all.

4.2 Internal audit's role in risk identification and evaluation

In order to address the second objective of the study, respondents were questioned on how internal auditors identify and evaluate risks.

4.2.1 Identification of risks

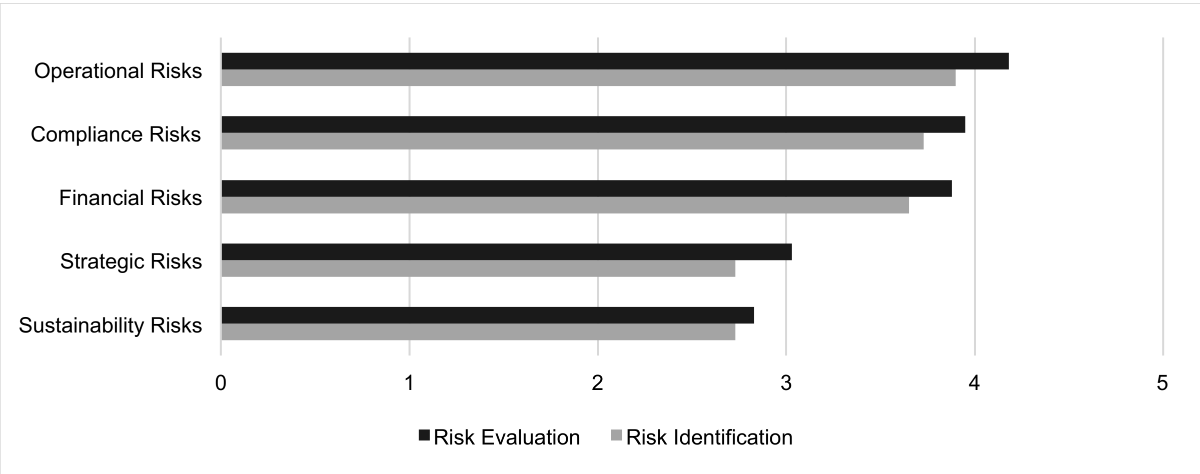
Responding CAEs agreed that internal auditors require relevant experience in order to assist the organisation with risk identification (both current (mean = 4.4) and emerging risks (mean = 4.25)). They also agreed that internal auditors are both competent and appropriately experienced to identify risks (means = 4.08 and 4.13 respectively), and to evaluate risks (means = 4.03 and 4.03 respectively). CAE respondents did however agree that internal auditors are more competent to identify current risks (mean = 4.23) than emerging risks (mean = 3.78). The Spearman's Rho rank-order correlation coefficient was used to determine the statistical significance of and the strength of the relationship between (1) CAEs indicating that internal auditors are competent to identify current risk, and (2) internal auditors requiring relevant experience in order to identify current risks. Results indicated that the relationship between responding CAEs indicating that internal auditors are competent to identify current risks, and internal auditors requiring relevant experience in order to identify current risks, was positive and of moderate strength. This relationship was statistically significant at the 1% level of significance ($p=0.009$, $p<0.01$). It could therefore be concluded that internal auditors' experience in risk identification has a direct influence on them being regarded as competent to identify current risks.

The Spearman's Rho rank-order correlation coefficient was used to indicate the relationship between the level of agreement with the assertions (1) that internal auditors' role in risk related activities is largely defined by the audit committee, and (2) that internal auditors require relevant experience in order to identify current ($p=0.120$, $p<0.05$) and emerging ($p=0.649$, $p<0.05$) risks. The correlation was found to be positive but weak, and not statistically significant at a 5% level of significance. However, the relationship between the level of agreement with the assertions (1) that internal auditors' role is largely defined by the senior/executive management, and (2) that internal auditors require relevant experience in order to identify current ($p=0.007$, $p<0.01$) and emerging ($p=0.004$, $p<0.01$) risks, was positive and of moderate strength, and statistically significant at the 1% level of significance. It can therefore be concluded that the more management is involved in defining internal auditors' role in risk management, the more experience internal auditors are required to have. It could alternatively indicate that the more management is involved in defining internal auditors' role in managing risks, the more internal auditors are involved in risk identification, and therefore are seen to have the relevant expertise to identify current and emerging risks.

The Spearman's Rho rank-order correlation coefficient indicated that the relationship between CAEs indicating that their IAFs are competent to identify risks and to evaluate risks was positive, of moderate strength, and statistically significant at the 1% level of significance ($p=0.000$, $p<0.01$). CAEs' responses therefore indicate that there is a direct relationship between internal auditors being seen as competent to identify risks, and being seen as competent to evaluate risks. However, from the results reflected in Figure 2, it is clear that internal auditors contribute more to the evaluation of risks than to the identification of the different types of risks.

Responding CAEs indicated that internal auditors, when identifying and evaluating risks, focus more on operations, compliance, and financial risk than on strategic or sustainability risks (refer to Figure 2). This suggests that internal auditors may still not be focussing on the core (strategic and sustainability) risks faced by organisations.

Figure 2: Identification and evaluation of risks

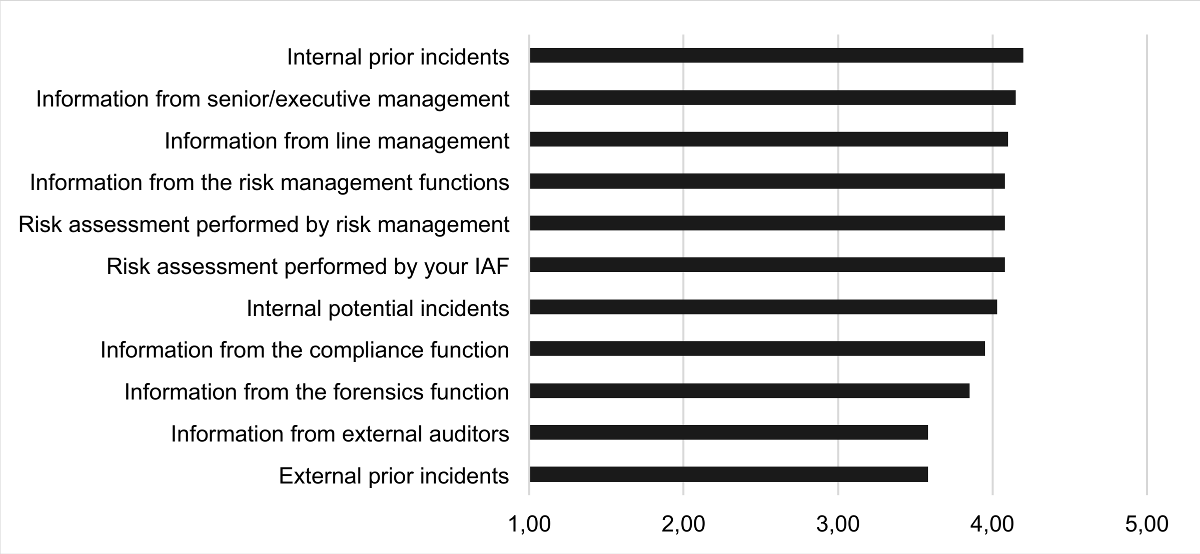


(<1.5 = no contribution, 1.5 to 2.49 = little contribution, 2.5 to 3.49 = moderate contribution, 3.5 to 4.5 = large contribution, >4.5 = highly significant contribution)

4.2.2 Sources of information for risk identification

The survey results collected for this study support previous literature indicating that a diversity of sources of information should be considered by internal auditors when identifying risks (O'Reilly-Allen & Mawn 2011:32; PwC 2008:9). CAE respondents were requested to rate the importance of various sources of information used by their IAFs to identify risks (refer to Figure 3 below). From these results it was clear that it is very important for internal auditors to consider all sources of information in order to identify potential risks. The most important sources of information are prior incidents that have occurred within the organisation and information from senior and executive management. These are followed closely by information from line management and risk management functions, as well as information obtained through risk assessments performed by the risk management function and the IAF.

Figure 3: Sources of information to assist the IAFs to identify risks



(<1.5 = No importance, 1.5 to 2.49 = little importance, 2.5 to 3.49 = moderate importance, 3.5 to 4.5 = very important, >4.5 = extremely important)

The Mann-Whitney nonparametric test indicated that statistically significant differences exist, at a 5% level of significance, between financial services and manufacturing organisations. It indicated that internal auditors within manufacturing organisations tend to consider prior incidents which have occurred within the organisation ($p=0.016$, $p<0.05$) and information from line management ($p=0.05$, $p<0.1$) more important in identifying possible risks (mean rank amounted to 12.5 and 11.75 respectively) than do internal auditors within financial services organisations (mean rank amounted to 7.09 and 7.50 respectively). This could indicate that for some sectors risk is predominantly operational, which means that internal auditors would tend to rely more on information that is readily available within the organisation.

When respondents were requested to indicate which risks/processes they would include in the IAF's audit plans, it was clear that the plan should be intensely focused on potentially significant risk processes which could impact the achievement of organisational objectives (mean = 4.18), followed by past significant risk events (mean = 3.65), and risk processes/areas not audited before (mean = 3.55). There was little support for or focus on the lower risk processes/areas (mean = 2.35).

4.2.3 Evaluation of risks

When evaluating risks, responding CAEs agreed that risk impact should be considered in both a qualitative (mean = 4.20) and quantitative (mean = 4.23) manner. The Mann-Whitney nonparametric test indicated that a statistically significant difference exists, at the 5% level of significance, between responses from financial services organisations and manufacturing organisations, with regard to their levels of agreement with statements viewing risk impact in a qualitative manner. There was a statistically significant difference, at the 10% level of significance, between financial services and manufacturing organisations, with regard to their levels of agreement with statements viewing risk impact in a quantitative manner. Financial services internal auditors are more likely to consider risk impact in a qualitative manner (mean rank is 10.64), than are internal auditors in manufacturing organisations (mean rank is 6) ($p=0.47$, $p<0.05$), whereas internal auditors in manufacturing organisations are more likely to consider risk impact in a quantitative manner (mean rank is 11.67) than are internal auditors in a financial services organisations (mean rank is 7.55) ($p=0.69$, $p<0.1$).

Where IAFs do not have the required level of knowledge or experience to evaluate specific risk areas, CAEs agreed that they would mostly outsource those areas to external service providers (mean = 4.00). Surprisingly, a few respondents indicated that, in some instances, they would simply not evaluate those areas at all (mean = 2.88), or they would attempt to perform those services with the expertise available within the function (mean = 2.73). Internal auditors may attempt to perform these services in order to provide some form of assurance to the organisation, which is better than no assurance being provided at all. However, it could result in internal auditors providing false assurance to the organisation due to them not having the expertise to evaluate those activities effectively.

5 CONCLUSION

The literature review indicates that organisations are continually exposed to new risks and that in order to manage these risks effectively and efficiently, and to achieve their objectives, the board and management need to be well prepared (Boyle & Boyle 2013:5; Mitroff & Alpaslan 2003:6; Payne 2002:21) and develop risk response strategies and processes (risk avoidance, risk mitigation, risk transfer or risk acceptance) (COSO 2009:2-3; Department of National Treasury 2014; Jaques 2007:151). Internal auditors' knowledge of risk management techniques, organisational processes, and internal control systems enables them to play an important role within this sphere of an organisation. The literature provides formal guidance outlining internal auditors' core role (which relates to assurance activities), and other legitimate roles (which relate to consulting activities) that internal auditors could perform, provided the necessary safeguards are in place. In addition these authors indicate specific roles that internal auditors should not undertake. Although previous research has identified internal auditors' risk management roles (De Zwaan *et al* 2011; Gramling & Myers 2006; IIA 2009a:4; IIA 2004:1-2; Sobel 2011:10), these studies have not considered a South African perspective, a gap which the current study attempts to fill. This study therefore has attempted to determine the nature and extent of internal auditors' risk assurance and consulting roles within South African organisations, as well as how internal auditors identify and evaluate risks within organisations.

Based on the literature describing previous research, a questionnaire was designed for online completion. A total of 40 responses were received. A statistical analysis was performed to establish the strength and statistical significance of the different survey questions, and their relationships. Survey results indicate that internal auditors are both competent and appropriately experienced to provide assurance and fulfil consulting roles in risk management. Their knowledge of organisational processes, internal control systems and risk management techniques enables them to play a significant role in managing risk within an organisation. However, this role is largely defined by the audit committee and management.

Although various factors were identified that influence internal auditors' ability to provide both assurance and consulting activities (some of which have more prominence in the financial services sector than in the manufacturing sector), CAE respondents agreed that it is internal auditors' knowledge of the business that is the most influential. CAE respondents also agreed that their IAFs are both competent and experienced, understand how the organisation operates, and appreciate the risks threatening the organisation, and that they are therefore ideally positioned to provide consulting and assurance services to the organisation.

The results of the survey largely confirm previous research relating to internal auditors' performance of their legitimate roles, and attitudes to the roles they should not perform (De Zwaan *et al* 2011; Gramling & Myers 2006). Respondents recorded a low level of agreement with statements regarding performance of so-called management roles relating to risk management, with the management activity performed most frequently by IAFs being the implementation of risk management processes.

Responding CAEs agreed with assertions that internal auditors require relevant experience in order to assist the management of the organisation with risk identification (of both current and emerging risks), and that internal auditors have both the competence and the experience to identify and evaluate risks. However, respondents saw their IAFs as more competent to identify current risks than emerging risks. When identifying and evaluating risks, responding CAEs indicated that internal auditors tend to focus more on operational, compliance and financial risks than on strategic and sustainability risks, and that internal auditors contribute more to the evaluation of risks than they do to the identification of the different types of risks. In response to the various methods used in identifying potential risks, CAE respondents agreed that the most important method for identifying potential risks was to consider prior incidents of realised risk within the organisation. This requires that internal audit plans should be strongly focused on processes with significant risk potential that could impact the achievement of objectives. The second-most important indicator was seen as previous significant risk events that materialised. The respondents placed significantly less importance on the lower risk processes/areas. While respondents agreed that both the qualitative and quantitative aspects of risk should be considered, it appears that in the financial services sector, more emphasis is placed on qualitative aspects than is done in the manufacturing sector. The research results confirmed that where their IAFs do not have the required level of knowledge or experience to evaluate specific risk areas, CAEs would mostly outsource those areas to external service providers.

The study found that South African internal auditors have relatively high level involvement in fulfilling core risk management roles and, with previous research having found only moderate involvement in assurance and consulting roles by IAFs, this represents an area for future research. This might indicate that there is a difference of understanding as to what it means to provide risk consulting and assurance activities, as well as what the different activities entail. The study also found that some IAFs are still performing management functions, although this involvement was limited. Further research should be undertaken to explore the reasons for and drivers of this sub-optimal practice, in an effort to determine how IAFs can maintain their independence and objectivity in these circumstances.

Finally, the results indicated that in general when identifying and evaluating risks, internal auditors focus more on operational, compliance and financial risk than they do on strategic and sustainability risks. This could indicate that internal auditors may still not be focussing on the core risks faced by organisations. This too represents an area for future research, as does obtaining an understanding of the reasons as to why internal auditors are less involved in the identification and evaluation of strategic and sustainability risks.

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Internal auditing of model risk within banking institutions

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ABSTRACT

Faulty or improper usage of models has contributed significantly to financial and banking institutions' experience of damage to their reputations and profitability. Since the global financial crisis of 2008, regulators have become increasingly concerned about the soundness of decision-making processes underpinned by, and capital requirements derived from models. Additionally, banking institutions have now recognised that flawed models are a source of significant operational risk and reliance on them can have negative consequences. Based on the importance of and increased use of models, internal audit functions should be equipped to provide assurance and auditing services to such areas within financial institutions.

This research study investigates the broadening of the internal audit function's ambit to include robust coverage of model risk within banking institutions. A brief literature review on model risk within banking institutions is followed by an investigation into internal auditing expectations and requirements regarding the coverage of model risk. The quantitative research which was performed is described, and conclusions drawn as to the state of risk management, internal audit's coverage and the skills needed to effectively assess model risk. In addition, the degree to which these have become embedded in these organisations is assessed. The research paper concludes with a set of recommendations on how internal

Key words

Internal audit; model risk; models; model lifecycle; banking institutions; risk management

1 INTRODUCTION

Faulty or improper use of models has contributed significantly to the situation where banking institutions have suffered financial and reputational damage. This was unequivocally highlighted by the global financial crisis, and subsequent high-profile financial incidents which revealed fundamental errors in banking institutions' models (Moore & Brauneis 2008:24; Gerding 2009:129-130; Lumsdaine 2009:46; An, Deng, Rosenblatt & Yao 2012:546). As a consequence of the crisis, banking institutions are facing greater scrutiny by regulators over model risk (Dil 2012; OCC/FED 2011). Regulators have become increasingly concerned about the soundness of decision-making based on, and capital requirements derived from models (Conover 2009; Krishnamurthy 2013:1-2; Petitjean 2013), and have therefore significantly increased their emphasis on model governance (Dil 2012; OCC/FED 2011; Pace 2008:27-28). Notably, regulators have extended their guidance and narrowed their focus relating to risk management and control activities to include model development, implementation and use (OCC/FED 2011; Mays & Sangha 2012:13-18; Krishnamurthy 2014:56-57).

Banking institutions are heavily reliant on models in their financial and risk management activities (OCC/FED 2011:1; Krishnamurthy 2013:1-2). They are becoming more dependent on strategically important, highly sophisticated modelling techniques and analytics to inform their decision-making (Conover 2009:20; OCC/FED 2011:1). Banking institutions have acknowledged that flawed models are a source of significant operational risk and can have adverse consequences (Wu & Olson 2010:180; Monahan, Meyer, Embersit & Agarwala 2012:26; Xu 2013:12). Banking institutions have therefore recognised the need to improve their model governance and risk management activities. These institutions are adopting various initiatives to comprehensively identify risk throughout the lifecycle of their models (Mays & Sangha 2012:13-18).

Based on the banks' already significant and increasing use of models, internal audit functions should therefore extend their assurance activities beyond mere policy compliance. The research study investigates opportunities for internal audit functions to expand their role in banking institutions' model risk management frameworks by independently verifying whether model risk is being actively managed and controlled.

2 SIGNIFICANCE, PURPOSE AND LIMITATIONS

The global financial crisis, and the significant consequent losses due to faulty or improper use of models has resulted in an expansion of the responsibility for and focus by internal audit on the risks posed by model use (Monahan *et al* 2012:26-27; OCC/FED 2011:19; Protiviti 2013:3-4; PWC 2011:12). Internal audit should therefore ensure that their risk-based audit plan includes coverage of model risk, as it has become a significant risk to banking institutions. As outlined by Head (2009:5-6), internal audit functions should be able to adapt to changes in the risk landscape and thus focus on model risks and associated areas deemed critical by management.

The primary purpose and focus of this research study is to extend the knowledge of internal audit's responsibilities for the auditing of model risk within banking institutions. It investigates the broadening of internal audit's ambit to include robust coverage of model risk within banking institutions, by analysing internal audit's role within the model governance framework. The study aspires to provide internal audit functions with a greater understanding of their role in and the coverage required over model risk management activities throughout the model's lifecycle.

This research article is structured as follows:

- A review of literature on model risk and associated control activities within the banking industry is reported on. (The review highlights the expectations and requirements banks have of their internal audit functions to include audit coverage of model risk.)
- An analysis of the results of a quantitative research project (the literature study and an examination of secondary data) which draws conclusions on the current state of model risk management and internal audit's coverage thereof.
- A discussion of and presentation on how internal audit functions should enhance their approach to and coverage of model risk.

3 LITERATURE REVIEW

3.1 Model risk within banking institutions

Models are becoming increasingly central to the operation of banking institutions, as they are used in a variety of settings and contexts. However, these models are also becoming a source of increasing risk within the industry (FDIC 2005:1). Faulty or improper usage of models has had significant adverse financial and reputational consequences (Conover 2009:20; OCC/FED 2011:1).

3.1.1 Application of models

Models help financial institutions make strategic and complex business decisions within the context of their uncertain and complex operational environments. The use of mathematical models has also become increasingly important, as they are able to deal with large amounts of complex information efficiently and speedily (OCC/FED 2011:1; Krishnamurthy 2014:56).

Yoost (2013:21) emphasises that reliance on models is growing fast and that their use has expanded into an increasing number of areas, with a simultaneous growth in their importance and influence. The use of models is expanding because technological developments make this possible, and because the availability of data sets is expanding and growing more amenable to sophisticated statistical techniques (Yoost 2013:21; Krishnamurthy 2014:56). Consequently, models are being used on an increasingly broad scale in financial and risk management activities and in corporate decision-making.

The areas where models are most frequently used include the following (Pace & Robertson 2003:24; Pace 2008:28; KPMG 2012:6-7; Yoost 2013:21):

- Measuring and quantifying risk (e.g. probability of default (PD), loss given default (LGD), exposure at default (EAD), potential future exposures (PFE), value at risk (VaR), duration, convexity, counter-party exposure, annual earnings at risk (AEaR), economic value of equity (EVE), net interest income (NII), and valuation models);
- Initiating or making risk decisions (e.g. score-cards, lending models, risk-reward models, algorithmic trading tools, and financial planning);
- Credit portfolio management;
- Pricing models, profitability models and effective interest rates;
- Calculating impairments consisting of PD and LGD;
- Asset and liability management (e.g. client behaviour models, structural and product hedging, and prepayment models);
- Securitisation (e.g. cash flow and waterfall);
- Liquidity management;
- Operational risk management;
- Stress testing;
- Fraud detection;
- Applied economic forecasting, and
- Estimating regulatory and economic capital.

3.1.2 Models and model risk

Banking institutions predominantly use statistical and mathematical models. Schichl (in Kallrath 2004:28) describes a model as "… a real world objective which is represented by mathematical objects in a formalised mathematical language." These models can range from the use of sophisticated, complex and intricate mathematical, statistical or econometric methods to simple calculations with very few assumptions (CIA, 2008:15-16). Advanced skills from various disciplines are required for the development, interpretation and use of these models (Kancharla 2013:2). Mathematical models are often dependent on computer-based production systems that consist of several interconnected components (PWC 2009:2).

Prior to the guidelines published on 04 April 2011 by the Board of Governors of the Federal Reserve System (FED) and the Office of the Comptroller of the Currency (OCC) (OCC/FED 2011), there was no agreement on a single, standard definition of what constituted a model within the banking industry (Kogler & Vetrano 2007:93; Yoost 2013:22). However, regulatory authorities have now agreed on a universally accepted definition of the term "model", and a consistent classification of what comprises model risk (KPMG 2013:6).

The regulatory guideline (OCC/FED 2011:3) identifies a "model" as a "… quantitative method, system or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates."

Although the release of the regulatory guidelines has provided a high-level definition of a model, banking institutions still find it difficult and challenging to capture model risk under this classification. Conflicting views remain, and there is still debate within the industry and literature on the definition's interpretation and thus on which types of models, calculations, and statistical and econometric methods should be captured within their model inventory (Pace 2008:30; Yoost 2013:22). As a result, material differences exist within the banking industry regarding which criteria and principles should be used when defining a model (Mays & Sangha 2012:15). Additionally, there are concerns that regulatory guidance excludes particular quantitative models (i.e. complex computations not materially underpinned by estimates and assumptions) that are nevertheless often used (KPMG 2013:7). This can create uncertainty and inconsistencies about the types of models that should ultimately fall within banking institutions' model inventory.

Model risk, on the other hand, is defined by regulatory authorities (OCC/FED 2011:3-4) as the *"…* adverse consequences from decisions based on incorrect or misused model outputs and reports. Model risk can lead to financial loss, poor business and strategic decision making, or damage to a bank's reputation."

Model risk can originate from various sources and throughout the model's lifecycle. These include: flawed model design; incorrect methodology; inadequate testing; incorrect implementation; erroneous calculations, logic or algorithms; faulty estimates; incorrect data; faulty assumptions; imperfect model structure; incorrect or inappropriate use of existing models; lack of understanding by the user; false interpretation or application of results; unauthorised model changes or modifications; rapid deterioration of model performance; negligence by the user, and/or the use of an outdated model (Kogler & Vetrano 2007:90; CIA 2008:17; PWC 2009:2-3; Wu & Olson 2010:180; OCC/FED 2011:3-4; Monahan *et al* 2012: 26-27; Xu 2013:12).

3.1.3 Model risk management and related challenges

Model risk can lead to poor decision-making, introduce operational risk, and result in financial loss and reputational damage (Pace 2008:27; Keyes 2011:7; OCC/FED 2011:3). Model risk management has therefore become vital for reducing exposure to these adverse consequences in banking institutions.

Kancharla (2013:1) states that models have long been an essential component of practically all decision-making, risk management and analysis. However, in recent years models have dramatically increased in their sophistication and complexity. Mays and Sangha (2012:18) comment that banking institutions are increasingly being challenged to manage model risk as they would any other significant risk. Banking institutions are therefore attempting to understand and better govern their models through enhanced risk management activities. A well-defined and properly implemented model governance and risk management framework can assist financial institutions to better understand their models' strengths, weaknesses and limitations. This governance and risk management framework should ensure that model risk is limited at all phases of its lifecycle - the development, implementation, validation and use phases of the model (Moore & Brauneis 2008:25; Goldberg & Pleune 2008:20-22; Lynas & Mays 2010:44-45).

Additionally, the focus on model risk has been heightened as regulators have become increasingly concerned about the soundness of decision-making processes supported by and capital requirements derived from models. Regulators have recognised an urgent need to address model risk management practices within banking institutions and to intervene if necessary (Mays & Sangha 2012:13-18; Ernst & Young 2013a:10; Krishnamurthy 2014:56-57). Regulators have already taken many key initiatives in this regard, including the issuance of new supervisory guidelines and regulations, and shared their insights regarding the institution of more robust model risk management standards and practices.

Regulatory guidance focuses on three areas of managing model risk. These include (OCC/FED 2011; Dil 2012:47):

- Model development, implementation and use;
- Sound model validation processes, and
- Developing, employing and maintaining strong model governance. This includes policies and controls.

In addition to the guidelines provided by regulators, it is critical that banks independently implement model risk management practices that are beyond mere compliance with regulatory requirements, to actively mitigate model risk (Lynas & Mays 2010:45; Krishnamurthy 2013:6). Academics and practitioners alike agree that subsequent to the issuance of the new regulatory guidance, many banks have made positive advances in enhancing their model risk management activities (Mays & Sangha 2012:13-18; Dil 2012:47). Despite the progress, however, there are many banking institutions that continue to face practical challenges and that struggle to implement an effective model risk management framework (Krishnamurthy 2013:2; Krishnamurthy 2014:57). Their challenges include an unclear definition of what constitutes a model; the lack of a globally accepted set of best practices and interpretations of regulations; the absence of company-wide support; underinvestment in model validation functions; the vast number of models to validate; process weaknesses; lack of system and technology infrastructure; difficulty in quantifying materiality of models' outputs and conflicting consequences, as well as a lack of access to skilled and experienced human resources (KPMG 2012:12; IACPM 2014:8).

Behm, Epperson and Kalra (2013:4) postulate that many banks have failed to implement effective model risk management frameworks due to their generally fragmentary or restrictive approach to the managing of model risk. Lynas and Mays (2010:45) contrastingly recognise that an overly extensive model risk management framework can be injurious to the business (i.e. it adds significant costs, or its governance is too onerous), resulting in senior management avoiding the use of models altogether. Davies (2012:50) raises concerns that model risk management and validation processes can have high demands on scarce resources that are rapidly exhausted. Therefore, some banking institutions do not perform regular validation activities, or avoid them altogether. According to Lumsdaine (2009:47), there is an increasing concern that model management as a discipline is struggling to keep up with the rapidly-changing financial environment and with the pace at which banks operate and take decisions. Consequently, many institutions are not regularly updating of their models, nor assessing the data's relevance and the ongoing validity of the models' assumptions. Additionally, models are usually implemented on an information technology platform which itself severely limits transparency and thus auditability.

3.1.4 Model lifecycle

The model lifecycle reflects the ongoing initiation, development, implementation and use of models within a business process (PWC 2013:3). Since model risk exposure can occur throughout the model's lifecycle, the effectiveness of the model must be evaluated and validated at each stage (Krishnamurthy 2013:4).

3.2 Internal audit

The Chartered Institute of Internal Auditors states that the core role of internal audit is to assist the board and executive management to safeguard the assets, reputation and sustainability of the organisation. This function is performed by evaluating whether all significant risks are identified, controlled and appropriately reported on to executive management and ultimately the board. Internal audit has a responsibility to provide independent and objective assurance on the effectiveness of governance, risk management and internal control activities (CIIA 2013:6; CIIA 2014:1). Internal audit standards require internal audit functions to evaluate the effectiveness of risk management processes and contribute to the improvement of these processes (IIA 2012:11-12; IIA 2013a:1-2).

According to Head (2009:5-6), internal audit functions should be able to adapt to changes in the risk landscape, and focus these adaptations on critical risk areas. Dolan and Moran (2013:43) state that an adequate internal audit function ensures improved effectiveness in the identification of new and emerging risks and an appropriate audit response. Whalen and Holt (2013:63) emphasise that internal audit must redefine their mandate, moving beyond identifying compliance and financial reporting risks, to focus on risks critical to the organisation as a whole. This process includes identification of key strategic and significant operational risks. According to Murphy (2011:137), the importance of internal audit's role in banking institutions in the identification of risks and the provision of assurance regarding the effectiveness of controls has increased significantly.

Within banking institutions, model risk is classified as a significant risk (Keyes 2011:7) and therefore internal audit must play a major role regarding the provision of assurance activities addressing this risk. Although various research studies and professional publications are available in which model risk management and the requirements of model validation are discussed, there is little discussion on the role of internal audit, nor on the practical coverage required by independent assurance providers.

The literature review indicates that internal audit functions should play a crucial role in evaluating the model risk framework, and should evaluate whether risk management activities and controls are complete and effective. In particular, internal audit should evaluate the effectiveness and appropriateness of model risk management practices, policies, implementation testing and verification to ensure that model validation is robust and comprehensive (Pace 2008:28; Dil 2012:48, 50). Monahan *et al* (2012:27) point out that an adequate framework should incorporate all three of the following lines of defence. The first line of defence is manned by those responsible for owning, taking and managing the risk; the second line of defence is owned by those responsible for oversight and challenge, and the third line of defence is defended by those responsible for independent assurance (Ernst & Young 2013b:4). Internal audit's responsibilities within this framework should be to provide the independent assessment of the design, robustness and effectiveness of model risk policies and controls provided and maintained by the first two lines of defence (Ernst & Young 2012:2).

From a supervisory point of view, internal audit functions should have an increased role relating to providing assurance regarding risk exposure during the model lifecycle and related processes (OCC/FED 2011:19; PWC 2011:12; Ernst & Young 2013a:12). Regulator guidelines indicate that internal audit functions should have appropriate skills to assist in model risk management activities. Regulators propose that internal audit should assess the overall appropriateness and effectiveness of model risk management activities, including the framework's ability to address faulty or improper usage of models individually and in the aggregate (OCC/FED 2011:19).

Internal audit is required by regulators to verify and confirm that (OCC/FED 2011:19):

- Model risk policies are in place and that these policies are complied with;
- Validations are timeous and accurate, and that effective challenge is being applied;

- Records of model use are kept, and if models are subject to controls, that any weaknesses are appropriately identified;
- Model inventory is accurate and complete;
- Processes for determining and monitoring limits and usage are in place;
- Documentation standards, including risk reporting, are met by model owners and control groups;
- Procedures for updating and changing models are clearly documented and complied with; and
- Data used by models are reliable, accurate and complete.

Additionally, regulators recommend that, rather than duplicating model risk management activities for each model, internal audit functions should evaluate the robustness of the collected risk management activities (OCC/FED 2011:19; PWC 2011:12; Dil 2012:50). Conversely, Chambers (2013:16) points out that internal audit functions should develop a sturdy critical approach to each functional discipline and should perform more than just a "reviewing the reviewers" role within institutions.

The level and breadth of skills required for auditing model risk will be highly dependent on the diversity and sophistication of models used within a particular banking institution. Aksoy and Sezer (2012:1284) state that institutions have different internal auditing requirements and needs depending on their nature, size and complexity.

4 RESEARCH METHOD

Due to the increasing use of models and the associated challenges faced by banking institutions as outlined in the literature review, this study focused on internal audit's responsibility for model risk. The study investigated the broadening of internal audit's ambit to include robust coverage of model risk within banking institutions.

The first phase of the research investigated the state of model risk management practices (whether they are fully embedded within banking institutions), and the maturity of such practices. The investigation sought to gain an understanding of the current challenges and risks that could affect the practical implementation of a model risk management framework. The aim was to identify which risk aspects internal audit functions should focus on when performing audit activities relating to model risk. In the second phase, an empirical study was carried out to determine the degree to which internal audit functions have already responded to, changed and/or enhanced their assurance activities over model risk in the wake of new regulatory guidelines. Lastly, the research investigated whether the required skills, knowledge and competencies do in fact reside within currently operational internal audit functions.

The data sources comprised the results of three global surveys performed by Deloitte (2014), KPMG (2013) and Protiviti (2013) respectively. The 2014 Deloitte study was based on global model practices and was conducted among 96 different (functionally unrelated) financial institutions worldwide. The survey analysed model validation practices within these financial institutions.

The 2013 KPMG study examined model risk management practices in the financial services industry. More than 60 financial institutions in the United States (US) participated in the study. The respondents were drawn from a diverse cross-section of financial institutions and included international non-US banks, regional US banks and global banking institutions. The study was undertaken to confirm whether model risk management practices had been established for and within the industry.

The data for internal audit skills needed to audit model risk were extracted from the 2013 Protiviti internal audit capabilities and needs survey results. Over 100 study participants within the financial services industry were required to assess their level of competence, areas for improvements and industry challenges.

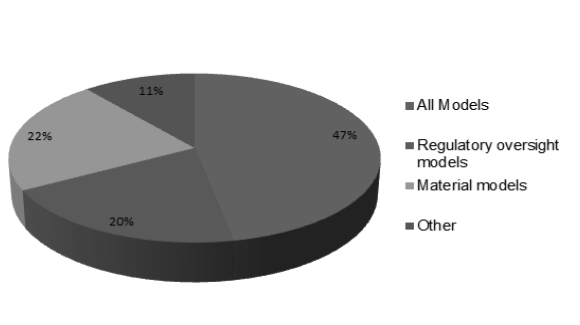
5 RESULTS

5.1 State of model risk management practices

The results of the surveys performed by KPMG (2013:2) and Deloitte (2014:24) indicate that many banking institutions are enhancing their capabilities and taking a more proactive approach to model risk management. However, inconsistencies remain, and there is significant room for improvement with regard to the application and implementation of model risk management practices. The challenges identified in the surveys included the uncertainty about defining and rationalising the terms model and model inventory, and determining which models to include in the validation process. Figure 1 shows the analysis presented by Deloitte relating to types of models being validated by financial institutions. This shows that around half of financial institutions validate all models, whereas some only validate material models or models subject to regulatory oversight. Furthermore, the analysis shows that approximately two-thirds of financial institutions indicate that model validation should include all models. This is illustrated in Figure 2.

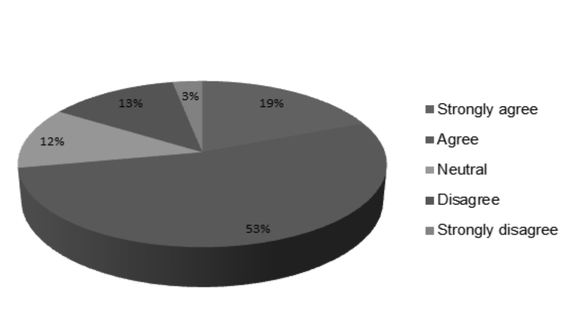
The results of the studies indicate that financial institutions remain uncertain and/or ambiguous in their efforts to assess model risk, adhere to validation cycles, and enforce validation findings. Findings further show that model risk management and validation activities are often decentralised, fragmented, incomplete or unreliable. Additionally, the studies show that model validation functions were under-resourced and that defining roles and responsibilities was challenging.

Figure 1: Type of models being validated



Source: Deloitte (2014: 9)

Figure 2: Model validation includes all models in scope



Source: Deloitte (2014: 8)

These results suggest that financial institutions are unclear about the number of models they have in place and uncertain if all models in use remain valid or are being used appropriately.

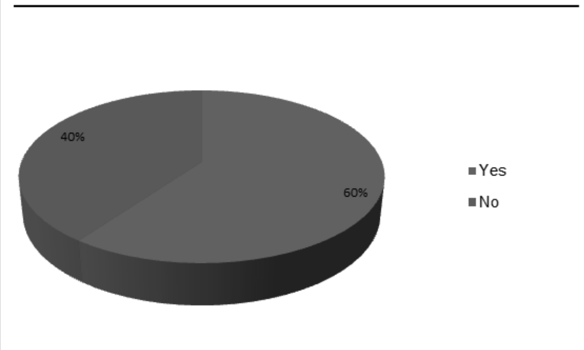
The results reflect various opportunities for internal audit to standardise and enhance model risk management activities in their institutions by making recommendations on how to streamline and improve model controls.

5.2 Internal audit coverage of model risk

The KPMG (2013:14, 16-17) study's scope included an assessment of internal audit itself. The survey investigated whether internal audit functions had changed their assurance activities to include the then proposed regulatory guidelines. Figure 3 illustrates the perception that internal audit's role in model risk management and model validation had changed positively. The results highlight that approximately 60% of the respondents had made some changes to the coverage provided by their model risk management practices. The changes made included a greater focus (allocation of time and other resources) on the audit of model risk policy, increased involvement in the challenge process, closer monitoring of the lines of defence and more emphasis on model-specific audits. However, 40% of the respondents indicated that the internal audit function's role in addressing model risk had not changed. This was most likely due to the inconsistent understanding of the required range and depth of internal audit procedures and approaches appropriate to model risk across institutions.

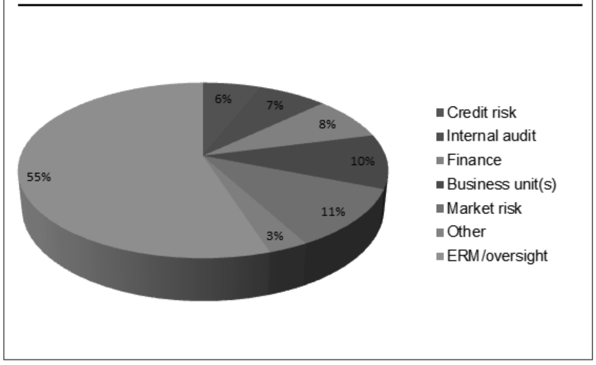
Figure 4 shows the allocation of responsibilities for model risk management governance (i.e. model risk management function). The results reflect that within the banking industry, the responsibility for model risk management rests with internal audit, business units, credit administration and/or finance. It was cited in the KPMG survey that this was a result of so-called legacy organisational structures. However, based on the three lines of defence model (IIA 2013b:4-6; Mays & Sangha 2012:14), researchers recommend that this responsibility should reside with the second line of defence. Internal audit should provide independent assurance and challenge the various components of the model risk management framework (Dolan & Moran 2013:42).

Figure 3: Has the role of internal audit changed?



Source: KPMG (2013: 17)

Figure 4: Model risk management governance responsibility

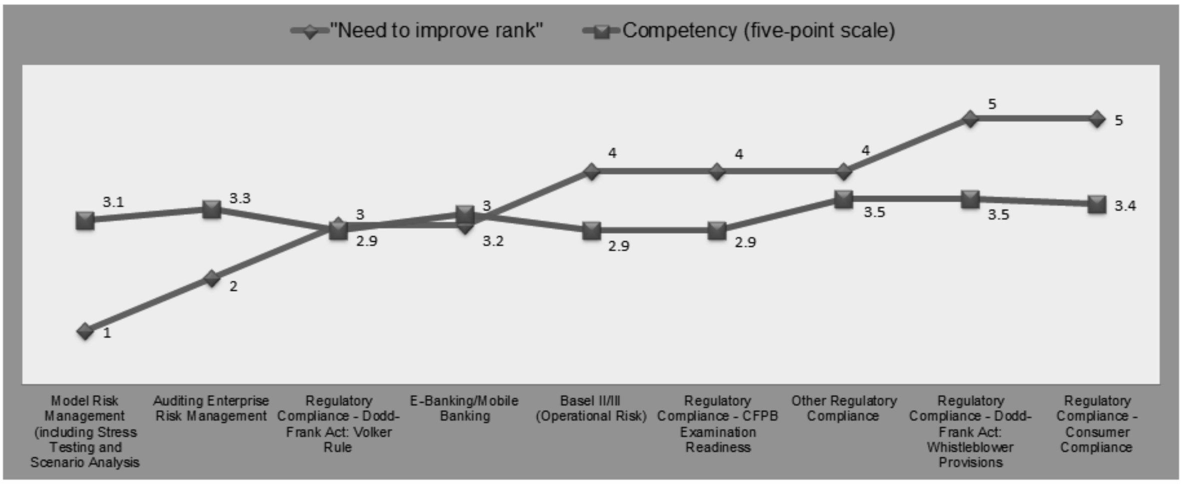


Source: KPMG (2013: 14)

5.3 Internal audit competencies and skills

An internal audit capability and needs survey conducted by Protiviti (2013:3-4) during 2013 highlighted that auditing model risk management was ranked as the number one area within financial institutions' internal audit functions that required improvement in competencies and skills. The results of the survey and study are highlighted in Figure 5. The reason for this specialised skill being cited as a challenge for internal audit is that the auditing of models requires high levels of quantitative and mathematical skills which are often scarce resources. This view is supported by Le Rice (2014:22), who recommends that internal audit functions in the financial sector should be required to employ mathematicians and data scientists. Furthermore, as highlighted by Bartolucci and Chambers (2008:66), the internal audit profession accepts that a lack of specialised skills, capabilities and capacity is collectively one of the primary challenges to their achieving their mandate.

Figure 5: Specific Technical Skills Needs



Source: Protiviti (2013: 3)

6 DISCUSSION

There continues to be inconsistency in the wide range of practices implemented by financial institutions relating to model risk. In particular, internal audit functions face challenges relating to coverage of model risk arising from their current audit procedures and approaches. Some of these factors can be attributed to the complexity, nature and size of the financial institutions. Additional factors include the absence of clear guidelines to the profession regarding the audit of model risk. Although regulatory guidelines have been made available for internal audit, uncertainty about their practical application persists, and the interpretation of these guidelines remains vague. Additionally, it has been established that internal audit functions lack specific skills and knowledge, resulting in their inability to appropriately cover model risk. The qualifications and skill sets required for auditing model risk is not discussed in detail in this research paper, and is proposed as a topic for further research.

In order for internal audit to have an impact on the coverage of model risk, it is proposed that they formally incorporate appropriate coverage of this risk in their audit plan. Given the sheer volume and complexity of available models, not all of them can be subjected to independent oversight by internal audit in a single audit cycle. Therefore, internal audit will be required to prioritise the coverage of specific models and model risk management activities. This should be performed based on the model's materiality (risk and use) and on the significance of the model's output to the entity. Internal audit should therefore vary their coverage and should utilise different approaches and types of audit review when assessing this risk.

Based on practical experience, focus group interviews and a literature review, a recommended audit approach for the coverage of model risk was developed. The proposed approach is illustrated in Table 2.

6.1 Model risk governance audit reviews

The aim of model risk governance audit reviews is to check that the board and executive management have set the tone and that a robust framework for their model risk assessments is in place. During these reviews, internal audit should verify that the institution has adequately developed the roles and responsibilities of the board, executive management, model developers, model owners and control groups in respect of model risk management activities. Internal audit should ensure that appropriate oversight is performed, and that segregation of duties, effective challenging and model performance reporting (model limits and restrictions) processes are in place. Internal audit should check that model approval processes have been established and are being followed for initial model approval and for ongoing use. Additionally, internal audit should verify that processes are in place to ensure the regular updating of model inventory. The institution must have formalised these activities and controls within its policies and procedures manuals. Table 3 outlines key issues that audit should verify are in place in these policies.

Table 2: Audit coverage of model risk

Audit Type	Examples of audit/audit focus areas
Model risk governance audit reviews	• Policies and standards • Senior management reporting • Model inventory management • Coverage plan and independent model validation • Documentation standards • Model approval
Business unit reviews covering models	• Model development and documentation • Review and approval of the use of the model • Data accuracy and completeness (historical data/model input data) • Correctness of model inventory • Implementation testing • Systems and accuracy of implementation • Post-implementation reviews • Model monitoring • Model validation • Change control over model code
Model-specific audit reviews	• Model code review • Mathematics review • Model methodology review • Re-perform validation tests • Model is in compliance with regulatory requirements
Regulatory audit reviews	• Risk-weighted assets calculation • Use test • Senior management awareness • Implementation of regulatory models • Self-assessments for regulators
Business monitoring	• Attend technical and monitoring committees • Management meetings/interviews • Audit issue follow-up • Review ongoing model performance monitoring reports, validation results and coverage • Tracking of model projects and control issues

Source: OCC/FED (2011); Davies (2012); KPMG (2012); Ernst & Young (2012); Ernst & Young (2013a); Board of Governors of the Federal Reserve System (2013)

Table 3: Auditing of model risk management policies and procedures

Audit focus areas	Auditing model risk requirement
Policies and procedures	Model risk management policies should be reviewed annually and updated on an ongoing basis. The policies should include the following aspects: • Model and model risk definitions • Acceptable and clearly assigned roles and responsibilities for the model owner, model developer, primary and secondary users, independent validation, control groups • Control requirements over model development, implementation, and use • Mandatory requirements for ongoing model validation activities, including validation framework and policies • Model classification and materiality (based on use and complexity) • Model inventory management • Appropriate oversight by the board and executive management • Procedures and approval authorities for the review and approval of new, changed and recalibrated models • Model documentation standards • Model reporting standards • Segregation of duties • Data quality framework and standards • Audit oversight.

Source: Kogler and Vetrano (2007: 90–93); Pace (2008: 28); OCC/FED (2011)

6.2 Business unit reviews covering models

The purpose of business unit review audits is to confirm that appropriately defined processes, methodologies and controls exist for model development, implementation and use at this level of the organisation. The extent of audit coverage and scope during these audits should be based on the materiality, complexity and extent of use of the model, as well as on the stage of the model in the model's lifecycle.

These audits must verify that data accuracy checks, model validation and model testing occur at each of the stages of the model lifecycle. Internal audit should ensure that model validation and model testing activities are rigorous assessments that facilitate credible challenges that identify model weaknesses and limitations. These validations should verify the stability and accuracy of the model and establish whether the model is performing in accordance with its design and intended business use. Appropriate action plans should address model weaknesses, and redevelopment plans should be in place for models performing sub-optimally. Table 4 outlines the audit testing of model validation.

Table 4: Auditing of model validation, monitoring and testing

Audit focus areas	Auditing model risk requirement

Model validation	• Validation was scheduled on the coverage plan and takes place as scheduled
	• Validation verifies that there is sufficient documentation and paper trail of the model's design
	• Verify that validation evaluates the conceptual soundness by assessing the quality of the model's design and construction. The validation should include the following analysis or sanity checks:
	  ∘ Efficiency/discriminatory power, accuracy/back testing, stability and convergence
	  ∘ Benchmarking or replication
	  ∘ Stress testing or boundary tests
	  ∘ Sensitivity analysis
	  ∘ Computational testing
	• Limits and triggers have been defined for the appropriate metrics, were consistently applied and the commentary provided was in line with the monitoring results
	• Validation includes the review of data integrity and data controls (missing data, input data validation; up to date data and frequent information refresh)
	• Judgment exercised in model development was reviewed for accuracy and appropriateness
	• Confirm effective challenge in the model validation process and that it was performed by an experienced and competent independent reviewer
	• Validation reviewed for any material model changes (model agrees to the approved model)
	• Validation identifies and communicates limitations of the model
	• Validation was reviewed and signed off by the model owner, business owner and control groups
	• Actions arising from the validation are logged, tracked and remediated in a timely manner

Source: Lynas and Mays (2010: 45 – 46); OCC/FED (2011); Davies (2012)

Additionally, audit should verify the completeness of the model inventory, correctness of the assigned model materiality, adherence to model documentation standards, existence of model change controls and appropriate storage of model data (input and output).

6.2.1 Model development

During the development phase of the model lifecycle, internal audit should assess the soundness and effectiveness of the model development procedures. Internal audit should check that model documentation produced by the model developer is sufficiently detailed to enable independent re-creation of the model. Model documentation should include the criteria set out in Table 5. In addition, the audit coverage should confirm that data quality, relevance and initial model validation have all been tested. The coverage should verify that new models, model changes or model recalibrations have all been appropriately approved prior to implementation and use.

6.2.2 Model Implementation

During the implementation phase of the model lifecycle, internal audit should verify that user acceptance testing, training, and implementation testing have been conducted and documented. Audit coverage of implementation testing should verify that data quality reviews have been performed and that the code has been tested. The nature of these tests and results should be documented, assessed and approved by the model and business owners prior to the model being implemented. Internal audit should check that the models have been applied in a controlled system environment with appropriate access restrictions and change controls. Additionally, internal audit should check that additional testing was completed after model results had been produced.

Table 5: Auditing of model documentation

Audit focus areas	Auditing model risk requirement
Model documentation	**Model overview** • Statement of purpose, overview of the approved use and nature of the decision the model will support • Description of the modelling approach • Model materiality • Roles and responsibilities (model developer, model owner, users) • Model history **Model theory and approach** • Detailed description of the methodology, model design, theory, logic, estimation techniques and key assumptions used • Known model weaknesses and limitations **Data utilised** • Model development data used including details of the data source, field definitions, allowable values and ranges, filtering rules, data cleaning and segmentation • Treatment of missing values and a justification for the approach chosen • Treatment of conservatism and how it is sufficient to account for data integrity and quality • Analysis of the accuracy, completeness and relevance of the data utilised **Model testing** • Detailed documentation on model testing including back testing, benchmarking (comparison of model predictions), stress testing, statistical measures, out-of-time and out-of-sample testing **Monitoring, limits and triggers** • Details of the proposed monitoring plan going forward • Details of the limits and trigger measures to be used to assess model performance **Governance and control** • Details of the testing and implementation plan, how changes to the model process are managed, data quality requirements and the treatment of model overrides

Source: PricewaterhouseCoopers (2013: 3 – 6); OCC/FED (2011)

6.2.3 Model use

During the use phase of the model lifecycle, internal audit should verify that appropriate controls are in place to ascertain whether the model is functioning effectively and being used appropriately, and that it is performing correctly over an extended period of time. Internal audit should check that model monitoring is carried out regularly and that independent validation is performed annually. Additionally, internal audit should verify that data accuracy and completeness controls are in place, and that overrides as well as post-model adjustments are being monitored.

6.3 Model-specific audit reviews

Model-specific audit reviews should be performed only on models with outputs that are material to the institution. Internal audit should verify for such a model that the model's methodology, conceptual soundness, approach and code are adequate and appropriate for its business purpose. The aim of these audits is to perform re-performance testing of the model's computer code or mathematical formulas to identify any potential flaws or weaknesses. The internal audit plan should include an analysis of the extraction rules applied by performing a line-by-line review of the code used, and should check that the code of the model corresponds to the approved and documented model method. During these audits, internal audit should challenge the model methodology used, and if the method underlying the model is uncommon, non-standard or unique, determine whether it is supported by professional journals or best practice guidelines.

Additionally, model-specific audit reviews should include performance testing of model monitoring and model validation controls. This includes the re-performance testing of model performance measurement calculations, triggers and metrics. The aim of these audit tests is to verify the quality of validation testing and the accuracy of validation results by verifying that internal audit obtains the same results as these control groups.

6.4 Regulatory audit reviews

Regulatory audit reviews of models should be risk-based, and follow a systematic approach to assessing that models comply with regulations. Internal audit should perform independent verification of the accuracy of financial information and other information derived from model use, which is reported to regulators. Some of the audits should include the review of risk-weighted assets, the use test, senior management awareness and model self-assessments requested by regulators.

6.5 Business monitoring

Business monitoring of model risk requires that internal audit performs an ongoing evaluation of the need for audit coverage of model risk and to timeously update the annual audit plan. The intention of business monitoring is to keep internal audit up to date on the ever-changing model risk environment within the banking institution, so that it may better understand emerging (unknown) or known model risks. Business monitoring of model risk should form part of internal audit's risk assessment processes that informs adjustments to the audit plan, the audit universe, internal audit reporting and periodic audit summaries as they occur.

7 CONCLUSION

Models have become central to the operation of banking institutions; however, they have been identified as sources of significant operational and reputational risk to these institutions. Banking institutions have therefore begun enhancing their model governance frameworks, enabling them to better manage and understand the risks posed by their use of models. Internal audit is identified as a critical component of this framework. Internal audit's responsibilities entail the independent evaluation of the effectiveness of the controls maintained by the first two lines of defence, thus requiring internal audit to prioritise model risk in their coverage and to enhance their associated assurance activities.

Conversely, internal audit should be practical about its coverage and assurance activities, given the high number and often extreme complexity of these models. To have an impact on the coverage of model risk, internal audit should employ an appropriate risk-based approach based on the complexity, materiality and extent of the models used. Employing the audit approach recommended in this research paper would allow for structured and practical coverage of specific models and model risk management activities. Through such regular internal audit reviews and effective challenge, internal audit would be able to enhance governance and risk management activities in respect of this significant risk.

Additionally, internal audit functions should enhance their capabilities and skills in order to provide audit assurance on the conceptual soundness, performance and use of models. However, this type of audit coverage will require experience and skills of a level significantly higher than those that are currently generally employed in the internal audit environment.

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Evolving Research

Structuring internal audit functions in multinational companies

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ABSTRACT

During the last five decades, the world has witnessed a dramatic proliferation of multinational companies (MNCs) that has evoked strong interest amongst academic researchers. Despite the acknowledged need to expand internal auditing activities to cover MNCs' diversified operations in multiple countries, only limited research has been performed from an internal auditing perspective. Drawing on institutional theory, this paper aims to add to the existing internal auditing literature by reviewing various international business management frameworks, in order to suggest an appropriate approach for the establishment and management of the internal auditing functions of MNCs. The study looks at the evolution of internal auditing functions in MNCs, examines organizational models described in international business management literature, and concludes that a geocentric approach is appropriate when structuring the internal audit function in a MNC. The argument is presented that geocentricity (which implies careful customization to address local context, while operating within established uniform standards) seems to be an appropriate approach for the organization of the internal auditing function of a MNC.

Key words

Auditing; internal auditing; multinational companies; globalization; geocentric model; local contexts

1 INTRODUCTION

Globalization, which implies cross-border trade and capital flows, and labor integration, has become one of the defining trends in today's world, bringing new opportunities and challenges for the business community (International Monetary Fund 2008). Nowadays companies simply do not seem to have any choice: if they want to expand and remain competitive, crossing the borders is an inevitable step in their development (Purdy & Wei 2014; Bobillo, Lopez-Iturriaga & Tejerina-Gaite 2012; Wiersema & Bowen 2008). In the last four or five decades the world has witnessed a dramatic proliferation of multinational companies (MNCs): according to the estimates of the United Nations Conference on Trade and Development, there has been a sixteen-fold increase in the number of MNCs - from 7,000 in 1969 to 111,000 in 2014 (World Trade Organization 2014:50). The expansion of local and nationally represented companies into global entities has changed the world and reshaped the way of doing business, and has consequently also raised new questions and set new performance standards for business executives.

The rapid expansion of the MNC phenomenon has evoked strong interest amongst academic researchers, who continue to develop various theoretical and empirically tested frameworks, in their efforts to describe and explain the still rampant proliferation of MNCs (Aggarwal, Berril, Hutson & Kearmey 2011: 558; Vachani 1999:537; Malnight 1996:43; Solvell & Zander 1995:17). But research into MNCs from an internal auditing perspective seems to be limited, despite the fact that various surveys have reported that internal auditing functions have to reposition themselves to represent companies operating on a multinational scale (IIARF 2010:20; Burnaby, Hass & Abdolmohammadi 2009:8). Drawing on institutional theory, the objective of this study is to add to the existing literature with regard to internal auditing in MNCs by suggesting an approach to follow while structuring multinational internal audit functions, and by identifying factors that should be considered in order to perform effectively across borders. Both the suggested approach and the factors to be considered emerged from an examination of pertinent international business management literature.

The developed body of knowledge on MNCs does not yet provide an agreed definition of MNCs, as scholars have their individually preferred, and usually different basic defining characteristics of global companies. Typically, though, these are based on the contribution of foreign sales, assets, and production to the company's total performance, the number of locations abroad in which the company operates, and the number of foreign employees on the payroll, amongst other criteria (Aggarwal *et al* 2011:558; UN 1973:4).

For the purposes of this paper, the definition adopted by the United Nations' Economic and Social Council in 1973 is preferred. This determines a MNC to be an enterprise that controls assets in two or more countries (UN 1973:5). The geographical distribution of the operations of a company has numerous implications for that company, posing challenges to its efforts to organize, coordinate and control its activities in different countries, cultures and contexts (Aggarwal *et al* 2011; Begley & Boyd 2003). These challenges are likely to be equally valid for the internal audit functions of MNCs.

2 THE RESEARCH QUESTION AND METHODOLOGY

This study is based on a review of published research literature. It is presented from an institutional theory perspective and considers international business management concepts. It aims to answer the following research question:

How should internal audit functions of MNCs be structured?

The remainder of this paper is structured as follows. Starting with the discussion of institutional theory as the conceptual underpinning of the study, it offers an historical perspective of the development of internal audit in MNCs. Drawing on various international business management concepts, an effective approach is then suggested for internal auditing in a MNC, and the factors that need to be considered by directors and managers are discussed. The paper concludes by identifying areas for future research.

3 INSTITUTIONAL THEORY

This study is presented from the perspective of institutional theory. This theory is used to understand organizational behavior as set in and influenced by other organizations, as well as broader cultural rules and beliefs (Heugens & Lander 2007). In their seminal work, DiMaggio and Powell (1983) identified three mechanisms through which convergence occurs, as organizations seek to become isomorphic (similar) with their contexts: these mechanisms are categorized as *coercive, normative* and *mimetic*. They argue that pressures for conformity exist in a business/industrial field and these result in sets of homogenous organizational forms (DiMaggio & Powell 1983; Lawrence 1999).

Several studies in internal auditing have adopted institutional theory as their starting point (Endaya & Hanefah 2013; Mihret, James & Mula 2010; Arena & Azzone 2007; Arena, Arnaboldi & Azzone 2006; Al-Twaijry, Brierley & Gwilliam 2003). Arena and Azzone (2007), Arena *et al* (2006), as well as Al-Twaijry *et al* (2003) have investigated the development of internal audit departments in companies in Italy and Saudi Arabia, from the perspective of institutional theory, and all considered *coercive, mimetic* and *normative pressures* to be relevant drivers, capable of explaining the development of the internal audit functions. *Coercive pressures* originate from formal and informal pressures exerted on organizations, which impact internal audit activity; *mimetic pressures* make companies replicate the organizational structures and processes of companies perceived as more legitimate; *normative pressures* are associated with the influence exerted by internal auditing's professional bodies (Mihret *et al* 2010; Arena & Azzone 2007; Arena *et al* 2006; Al-Twaijry *et al* 2003).

Regulatory requirements that affect the internal controls of MNCs represent the formal side of *coercive pressures.* Firstly, the laws and regulations of the country of operation may require/compel the presence of an internal audit function. Secondly, the increasing global demand for accountability, transparency, sustainability and social responsibility substantiate internal auditing's value as an important assurance function, that thereby contributes to the stakeholders' demands for ongoing improvements in corporate governance (Thomson Reuters 2013:4; IIA 2012:11; Sarens, Abdolmohammadi & Lenz 2012:191; Soh & Martinov-Bennie 2011:605; Gramling, Maletta, Schneider & Church 2004:195). In addition, internal auditors are expected to provide enterprise-wide assurance regarding internal controls' compliance with various control frameworks, including those of the Committee of Sponsoring Organizations of the Treadway Commision (COSO), and specific regulations with extra-territorial reach, such as the United Kingdom's Bribery Act, the United States' Foreign Corrupt Practices Act and the Sarbanes-Oxley Act, and the European Union's Data Protection Directive, amongst others (Stippich & Blackwell 2012: 67; Arena & Azzone 2007:94; Arena *et al* 2006:281; Vanasco, Skousen & Verschoor 1995:23).

Informal *coercive pressures* originate from the need to align internal audit activities with the strategic needs of companies operating globally. The effective performance of an internal audit function is thus dependent on a sound understanding of the environment (in all its business and social nuances), and addressing both its formal and informal pressures (Chambers & McDonald 2013:4; Thomson Reuters 2013:11; Stippich & Blackwell 2012:67). This is acknowledged to be an understanding that is difficult to gain without a physical presence in the foreign location.

Although locally based professional bodies exert *normative pressures* on the development of internal audit departments in certain countries, due to their regional promotional activities (Arena & Azzone 2007; Arena *et al* 2006; Al-Twaijry *et al* 2003), from the perspective of MNCs it is the influence of global professional bodies, represented primarily by the Institute of Internal Auditors (IIA), that informs the formal pressures referred to above.

Mimicry refers to the copying of the practices of similar organizations in the same field (Mihret *et al* 2010:228; Arena & Azzone 2007:95; Arena *et al* 2006:280; Al-Twaijry *et al* 2003:512). It has been a common but not universal practice for internal audit functions in MNCs' foreign offices to follow the home-base/head office model (some variations of organizational structures of internal audit functions were also found). In a study on the development of internal auditing in the UK Liu, Woo and Boakye-Bonsu (1997:470) found that UK companies with multiple international locations tend to choose a divisional structure, with a decentralized system of authority. However, according to Pricewaterhouse-Coopers (PwC) (2007:16) the emerging trend is the creation of hybrid structures like the "hub and spoke" organizational model preferred by global external audit firms; the corporate hub is located in the home country/head office, with spokes supporting the main areas of operations. This model gives the MNC all the benefits of maintaining an internal audit presence throughout the company, while keeping certain specialized (more costly, and less frequently used) functions at the headquarters. This organizational model allows the MNC to achieve a high level of centralization, while allowing some local autonomy that enables the local operation to respond to location-specific operational issues (Moeller 2009: 285). The organizational anatomy of internal audit is thus likely to resemble the organizational structures of other functions and divisions within a global company, which indicates a response to mimetic pressure. In the next section, a historical perspective on the development of internal audit in MNCs is presented.

4 HISTORICAL PERSPECTIVE ON THE DEVELOPMENT OF INTERNAL AUDIT IN MULTINATIONAL COMPANIES

Even though there is a substantial body of knowledge on the organisational and operational aspects of MNCs (Aggarwal *et al* 2011:538; Vachani 1999:537; Malnight 1996:43; Solvell & Zander 1995:17), research specific to their internal audit functions is limited. This is despite the widely recognised potential of the internal audit function to add significant value to the entity (Murdock 2006:29; Tucker 1998:29). The unique position and ability of internal audit to assist management in the control and coordination of foreign operations seems not to have been leveraged: 50% of US-based MNCs surveyed in 1971 claimed to have conducted no internal audits of their foreign affiliates (AlHashim 1980:38), while in 2010 39% of respondents to a similar survey indicated that their home location internal audit functions perform only some of their organization's global internal audit activities (Stippich 2011:1).

4.1 Pre 2000

Okopny (1985:49), reviewing the then existing literature in the field of international internal auditing, argued that publications available before 1985 were mainly focused on the practical considerations of travelling abroad, although these studies did also emphasize the perceived role of internal auditing as an effective tool to ensure better understanding of international business activities and their inherent risks. Later research was designed to help auditors not only to plan their travels, but also to identify some of the unique challenges they might face when away from their home locations. These challenges included cultural and regulatory differences, country-specific risks and business practices, and the diverse levels of maturity of the internal audit profession around the world, all of which had to be considered at the planning stage of international assignments (Murdock 2006; Tucker 1998; Sears 1994). The home-base model, which represents a centralized internal audit approach, was thus dominant in the internal auditing professional literature up to the turn of the century.

4.2 2000-2005

While the companies were trying to gain additional competitive advantages through increasing the number and integration of their cross-border operations, the research published at this time was largely devoted to investigating the impact that globalization might have on the internal audit profession, particularly the expansion of the roles and responsibilities of the internal audit function, and the associated changes to the skill set required of the individual internal auditors (Sumners & Soileau 2008:1; Baker 2007:46; Bartolucci & Chambers 2007:64; PwC 2007:13). The progression towards risk-based auditing made internal auditors responsible for the timely identification and assessment of emerging risks, and the challenges a MNC might face in the course of its foreign activities, as well as the evaluation of potential business opportunities that could be capitalized upon through expanded worldwide operations (Bartolucci & Chambers 2007; Zhang 2002).

Another emerging trend in the internal auditing area of the early 2000s, which was attributable to globalization, was the practice of co-sourcing, or partial outsourcing. Contracting outsiders/others to perform internal audit services was acknowledged by practitioners to be a viable business option (IIA 2013:11; Ernst & Young 2010a:9; Serafini, Sumners, Apostolou & Lafleur 2003:65), and its numerous benefits and possible pitfalls were extensively examined (Ernst & Young 2010b; KPMG 2008; Schneider 2008; Van Peursem & Jiang 2008; Watson 2007; Del Vecchio & Clinton 2003; Serafini *et al* 2003). The most sought-after advantages of the co-sourcing internal audit model for MNCs wishing to expand internal audit coverage of their foreign operations were that local co-sourced organizations could provide industry-specific knowledge and expertise in local legislation and business customs. They were also able to draw on relevant experience in the same industry segment and provide valuable information on country-specific risks, all of which enabled the MNC to respond more effectively to the increasingly stringent demands of stakeholders, without increasing travel costs (KPMG 2008:4; Watson 2007: 29; Del Vecchio & Clinton 2003:34; Serafini *et al* 2003:62).

Although the notion that foreign operations demand specific approaches had some support (Murdock 2006; Zhang 2002; Sears 1994:28), the predominant trend in the early 2000s was still the centralization of the internal audit function. According to a study conducted by PwC (2007:16), 54 percent of respondents expected internal auditing to be based in a central location, with only a few functions existing internationally, while 37 percent of respondents insisted on one central internal audit function being established and maintained in the home country. Thus, barely a decade ago the home-base model for MNCs' internal audit functions was still strongly supported. This deduction was confirmed by Murdock (2006:29), who suggested that at that time "the conventional audit department is centralized and typically located near the company's headquarters".

4.3 Beyond 2005

Over the past decade the rapid growth of cross-border business integration has challenged internal auditors to expand their activities to cover diversified operations in multiple countries (Stippich 2011:1; Baker 2007:48; Bartolucci & Chambers 2007:64; PwC 2007:13; Murdock 2006:24; Protiviti 2006:i; Zhang 2002:40). Effective and efficient internal audits of foreign operations could no longer be performed remotely and demanded the physical presence of internal auditors, motivating the establishment of internal audit functions in foreign locations (Moeller 2009:283; Baker 2007:48; Bartolucci & Chambers 2007:65; Murdock 2006:29). More recently, publications in the field of internal auditing have increasingly indicated the need to move internal auditing abroad (Protiviti 2012; Stippich & Blackwell 2012).

In recent years researchers have begun to emphasize the need to expand internal auditing's responsibilities as a result of the growing awareness of its contribution to corporate governance (IIARF 2014:81; Soh & Martinov-Bennie 2011:618; PwC 2007:38; Brody & Lowe 2000:170). According to Sarens *et al* (2012:197), the scale of the international operations of a company is likely to determine the level of involvement of the internal audit function in corporate governance issues. Similarly, the expanding roles and responsibilities of the internal audit function have required the function to expand its essential skills set (Sumners & Soileau 2008:1; Bartolucci & Chambers 2007:66; PwC 2007: 37; Murdock 2006:24).

Performance standards for internal auditors comprise their deep technical expertise (including country-specific knowledge), their ability to adjust to the unfamiliar environment of a foreign country, and their abilities to communicate with stakeholders with a diversity of specific and special interests (IIARF 2014:86; Chambers & McDonald 2013; Murdock 2006:25). Previous studies have identified that the following requirements are crucial for MNCs' internal auditors:

- *Language skills.* Internal audit executives were advised to recruit people with the ability to speak the languages of those countries where they have most operations (Murdock 2006:24; Powell 1993: 54).
- *Diversity and flexibility.* Multinational auditing implies dealing with different ethnicities, nationalities, ages, and cultures. Internal auditors should therefore be able to adapt to different thinking and management styles in order to develop collaborative and mutually beneficial relationships, to understand the local system of values, and to respond rapidly to changing business conditions (Chambers & McDonald 2013:8; KPMG 2008:5, Murdock 2006:29).
- *Continuous learning*. Effective auditors should be able to absorb new information. They should show reasonable knowledge of important international laws covering internal audit issues, international legislation, and compliance rules, and additionally, they should monitor the latest global developments and changes that might affect the company (Chambers & McDonald 2013:9; Burnaby & Hass 2011:752; Baker 2007:46; Allegrini, D'Onza, Paape, Melville & Sarens 2006:852; McDonald 2003:47; Vanasco *et al* 1995:28).

The movement from a home-base model for internal auditing towards a decentralized model can be substantiated from the perspective of institutional theory, which considers the environment to be the key factor determining the behavior of organizations.

5 INTERNATIONAL BUSINESS MANAGEMENT CONCEPTS

The literature stream on MNCs offers extensively discussed and empirically tested frameworks of organizing principles and management systems for established cross-border operations. The fundamental typology of management practices of MNCs was developed by Perlmutter (1969), who identified the following definitive organisational attributes: *ethnocentric*, where the headquarters replicate home country practices for foreign operations; *polycentric,* where local differentiation is recognised; and *geocentric,* where a collaborative approach between geographically dispersed locations is effected, which enables the development of global standards for all the MNC's constituent entities worldwide. European companies have historically been considered as polycentric (Miroshnik & Basu 2014:3; Malnight 1996:46; Perlmutter 1969:13), reflected in their preference for a decentralized country-centered strategy of control, as seen in a majority of UK companies. American MNCs, contrastingly, have traditionally given preference to the ethnocentric model (Miroshnik & Basu 2014:3; Malnight 1996:46). Recent international business literature indicates a change away from both centralized and decentralized organizational models for MNCs towards a network-based approach (Miroshnik & Basu 2014:3), which is also being applied for control systems of MNCs (Betts, Laud, Mir & Vicari 2012:5).

Perlmutter's (1969) classification of the above-mentioned concepts of "centrisms" was derived primarily from the attitudes of management on headquarters' orientation towards subsidiaries of a MNC (Hedlund 1986). Table 1 presents the organisational attributes considered.

Nearly two decades later Hedlund (1986) expanded on Perlmutter's original concept. He identified the concept of a "heterarchical MNC" as a geocentric organization (Hedlund 1986:20). The heterarchical MNC differs from the abovementioned geocentric MNC in terms of its strategy and structure. The strategy of a heterarchical MNC is embedded in the notion of actively exploiting the advantages of multinationality (Hedlund 1986:20). Its structure is conducive to the achievement of both global integration and local differentiation (Hedlund 1986:21). This could mean that a heterarchical MNC has many centres and these centres differ in nature. Subsidiary managers are also given a strategic role within the MNC as a whole, more freedom and flexibility is provided to organizational units, while integration is achieved through normative control (for example the corporate culture becomes critical)

(Hedlund 1986:20-24). Hedlund (1986:24) sees a heterarchy as an organization "where information about the whole is contained in each part".

Table 1: Organizational attitudes used by Perlmutter

Attributes of the organization	Ethnocentric	Polycentric	Geocentric
Complexity	Complex in home country, simple in subsidiaries	Varied and independent	Complex and interdependent
Authority and decision-making	High in headquarters	Relatively low in headquarters	Collaborative approach between headquarters and subsidiaries
Evaluation and control	Home standards apply	Determined locally	Standards that are internationally accepted – also locally relevant
Rewards, punishments and incentives	High in head office, low in subsidiaries	Varies	International and local executives rewarded for reaching local and worldwide objectives
Communication and information flow	High volume to subsidiary offices – orders, commands and advice	Little to and from headquarter. Little between subsidiaries	Across subsidiary offices and headquarter. Heads of subsidiaries part of management team
Identification	Nationality of the owner	Nationality of the host country	International organization considering national interests
Recruiting, staffing and development	Recruit and develop individuals from home country for key positions elsewhere in the world	Develop individuals of local nationality for key positions in their own country	Focus on the most suitable individuals, regardless of country of origin – development for key positions everywhere in the world

Source: Perlmutter (1969)

Using Perlmutter's geocentric model (1969) as a departure point, later studies have attempted to construct typologies of MNCs, and the variables used can be summarized under the following broad headings: environment; strategy; structure, and systems and processes, the last of which includes control mechanisms and human resource management (Harzing 2000). In the review of theoretical approaches for MNCs, Pesalj (2011) maintains that a MNC is a differentiated inter-organizational network, which consists of a system of interrelated and interconnected organizational parts.

From the above it is clear that Perlmutter's geocentric model supporting a global mindset (Levy, Beechler, Taylor & Boyacigiller 2007:232) has spawned a stream of research showing the multidimensional heterarchical intra- and interfirm relationships forged by MNCs, rather than the vertical unilateral hierarchical relationships between headquarters and foreign subsidiaries that epitomizes an ethnocentric model (Tolentino 2002). MNCs benefit from the generation and transfer of resources and competencies from and between their foreign subsidiaries located in different parts of the world (Tolentino 2002).

Practices of external auditors, who seem to be facing the same challenges as internal auditors in relation to geographically dispersed work, mirror a geocentric approach. Audit arrangements across geographical boundaries are becoming prevalent in the operating styles of big audit firms (Hanes 2013:2). These assignments involve multiple locations and the effective coordination of work becomes a crucial factor for success (Hanes 2013; PwC 2013:11; Hegazy & Nahass 2012; Barett, Cooper & Jamal 2005). Multinational audits cannot be treated as imitations of existing domestic processes (Hanes 2013:2); auditing MNCs challenges audit firms to find the right balance between localization and globalization for their operations (Barett *et al* 2005; Cooper, Greenwood, Hinings & Brown 1998), epitomizing the geocentric approach, as described above.

As contemporary companies expand their foreign operations, the physical presence of internal auditors abroad has become a necessity (Stippich 2011; Murdock 2006). Although the traditional organisational structure of internal controls requires the adoption of a centralized model, the existing environment and the identified coercive, mimetic and normative pressures drive MNCs' internal auditing practices towards geocentricity, carrying with it a certain degree of autonomy for local internal audit units, while simultaneously requiring a global standardisation of approaches and standards that ensure enterprise-wide consistency of internal audits. Based on the review of international business management concepts it appears that internal auditing in MNCs should be approached from a geocentric perspective, with collaboration between geographically dispersed locations being promoted. The following section presents factors that should be considered when following a geocentric approach to structuring the internal audit function in a MNC.

6 FACTORS TO CONSIDER WHEN APPLYING A GEOCENTRIC APPROACH

MNCs are not homogenous. Thus, the structure of their internal audit functions, as with any other aspect of the enterprise, is determined by a variety of factors. These include the size, volume and diversity of operations; the nature of internal controls; the characteristics of the portfolio of risks; the overall objectives of internal audit, and the available resources (IIARF 2010; Moeller 2009:283). The geographical distribution of a MNC's activities adds a further dimension, challenging organisations to find a way to ensure consistent and adequate audit coverage of the entity's entire suite of operation (Moeller 2009:283; Chan 1995:44). Following a geocentric approach therefore, require internal audit functions to consider the need for customization of internal audit processes to accommodate the unique requirements of foreign locations, and to embed mechanisms that ultimately provide for enterprise-wide homogenization and the convergence of all its internal audit services.

6.1 Localization of internal auditing

The IIA seeks to achieve the harmonization of internal auditing practices around the world through its International Standards for the Professional Practice of Internal Auditing (Standards), and their other professional practice guidance (Vanasco *et al* 1995: 40). This follows directly from the stated mission of the IIA, and was reiterated by Richard Chambers (a past president and CEO of the IIA), when he stated: "the profession is poised to continue the realignment that has been going on for a couple of years" (Whitehouse 2011:6). Sarens and Abdolmohammadi (2011), in their empirical research found strong evidence of a high degree of convergence between internal auditing practices in different countries. But despite the acknowledged trend towards global uniformity of internal audit approaches, numerous comparative studies of internal audit practices have revealed substantial variations, both within regions and between countries, in the perceived roles and responsibilities of internal audit functions, and the way internal audit is performed (see, for example, the Common Body of Knowledge Research, conducted by IIARF (2014) which investigated internal auditing practices around the world; Paape, Scheffe and Snoep (2003) whose research focused on European Union countries; and Selim, Woodward and Allegrini (2009) who compared the internal auditing practices in the UK, Ireland and Italy).

Burnaby *et al* (2009:6) claim that the local context determines the way internal auditing is performed. This view is shared by Sarens and Abdolmohammadi (2011), who believe that the achievement of global convergence of internal auditing practices is inhibited by contextual variables. The diversity of internal auditing practices between (and within) countries substantiates the need for a sound understanding of contextual variables so as to achieve effective management of internal audit units in foreign locations.

Despite an exhaustive search, the authors have not become aware of any academic research in the field of internal auditing that provides a specific theoretical basis from which to examine the local contextual variations that might impact the internal auditing activity across national boundaries. In contrast, international business literature offers a myriad of theoretical and empirically tested frameworks aimed at identifying and assessing contextual variables, an understanding of which is necessary to effect a sound understanding of and embedding in a foreign local environment (Kimiagari, Keivanpour, Mohiddin & Van Horne 2013; Meyer, Mudambi & Narula 2011; Muritiba, Muritiba, Galvao de Albuquerque, Bertoia & French 2010; Vrontis, Thrassou & Lamprinou 2008; Tong & Reuer 2007). Meyer *et al* (2011:237) suggests two dimensions of local context variations: institutional frameworks and resource endowments. The applicability of these to internal audit will be discussed next.

6.1.1 Institutional frameworks

As companies have increasingly "gone global", and in the process been forced to face substantial differences in local work environments, authors of international business management literature brought the term "psychic distance" into mainstream discussions. Psychic distance addresses the differences in formal and informal institutions between countries, which have to be considered while setting up operations in foreign locations (Meyer *et al* 2011:240; Hakanson & Ambos 2010:195; Muritiba *et al* 2010:26; Hosseini 2008:947). Although the investigation of institutional differences in a variety of work environments has received substantial attention from business management researchers (Meyer *et al* 2011:240; Hakanson & Ambos 2010:195; Muritiba *et al* 2010: 26), there is as yet no standard definition of psychic distance. Muritaba *et al* (2010:27) identified the components of psychic distance as follows: *cultural distance*, including language, religion, and culture, which determines business practices; *administrative distance*, including the political system, legislative framework and educational background, and *economic distance*, which includes the state of industrial development of the "other" country. A review of relatively recent studies that have compared internal auditing practices in different countries indicates that all the abovementioned components of psychic distance affect internal audit activities (see Table 2).

As the aforementioned studies highlight, the components of psychic distance are believed to explain the identified differences in internal auditing practices around the world. One can therefore conclude that the existence of substantial variations in audit practices in different locations reflects responses to local economic, social, and political environments (Burnaby *et al* 2009:5) and that this might inhibit the replication of headquarters' internal audit approaches across other locations, and thus underscores the need to align internal auditing practices with their local context. It also represents the first factor that should be considered when determining the appropriateness of a geocentric approach for multinational auditing.

Table 2: Recent publications that highlight national differences in internal audit practices

Publication/Research title	The area of research	Identified components of psychic distance, which explain the differences in internal auditing practices		
		Cultural distance	Administrative distance	Economic distance
Internal audit around the world: a perspective on global regions. The Global Internal Audit Common Body of Knowledge (IIARF 2014)	The continuing development of the internal auditing profession around the world	X	X	X
Internal auditing in the Americas (Burnaby & Hass 2011)	Investigation into the demographics of internal auditors, their organizations' compliance with the IIA Standards, and their required skills and competencies in USA, Canada and Latin American countries	X	X	X
The relationship between the internal audit function and corporate governance in the EU – a Survey (Paape *et al* 2003)	The relationship between the internal audit function and corporate governance amongst the top listed companies in the European Union		X	
Internal auditing and consulting practice: a comparison between the UK/Ireland and Italy (Selim *et al* 2009)	Comparison of internal auditing and consulting practices performed by the IIA members in the UK, Ireland and Italy	X	X	X
Global internal audit and the changing public reports by management and the auditors of publicly held corporations: a comparative study of selected automakers in the United States, Russia and Japan (Pineno & Sigurdson 2009)	Comparison of internal auditing practices and internal control assessments in US, Russian and Japanese manufacturing companies	X	X	X
Internal auditors' perception about their role in risk management. A comparison between US and Belgian companies (Sarens & De Beelde 2006)	Comparison of the perceived roles of internal auditors in risk management between Belgian and US companies, located in Belgium	X	X	X

6.1.2 Resource endowments

The diversity of resource endowments (geophysical through intellectual) across locations is acknowledged in the international business literature to have played a crucial role in the global expansion of business (Meyer *et al* 2011:239). Applying this concept when considering a geocentric approach for multinational auditing, it is the skills and competences of the local internal auditing unit that represents the resource endowment dimension of local contexts' variations. In other words, the feasibility of making decisions at the local level would dictate the advisability and viability of establishing internal audit units in foreign locations.

The business research literature identifies the following benefits as accruing to local autonomy (Betts *et al* 2012; Williams & Van Triest 2009; Young & Tavares 2004; Begley & Boyd 2003; Taggart & Hood 1999; Perlmutter 1969):

- improved decision-making process due to better understanding of the local environment;
- local knowledge creation, derived from innovative potential of foreign locations, and facilitated knowledge transfer; and
- enhanced organizational communication.

By applying a geocentric approach, a MNC's internal audit function is likely to encounter the same outcomes, as the internal auditing literature supports the need for resource endowments. Local internal audit units would ensure a better understanding of the local environment, including legal and regulatory frameworks, business customs and practices (Stippich & Blackwell 2012:67; Murdock 2006:25; Sears 1994: 29). Local knowledge creation could result in a deep understanding of the operation and its related risks. This is a notion which is widely acknowledged in internal auditing literature, that business acumen and associated skills are indispensably fundamental amongst the wide range of "required" and "nice to have" internal audit capabilities (IIARF 2014:90; IIA 2013:17; PwC 2012:37).

Investigating multinational (external) audit firms, Barett *et al* (2005:21) emphasize that local offices make a significant contribution to the success of their global businesses by virtue of their locally created innovative approaches. By similarly aligning global internal audit practices with the innovative approaches developed and adopted locally, this may result in more widely appropriate internal audit approaches (Moeller 2009:284). That internal auditors create and disseminate innovations within their internal auditing processes is widely accepted. In addition, internal auditors are also believed to contribute to the competitiveness of the whole organisation through internal benchmarking that makes use of best practices identified across the entity's different locations, and by promoting their implementation throughout the MNC (Hyland & Beckett 2002).

Physical proximity to foreign stakeholders and enhanced communication with them should enable the alignment of internal auditing's role and responsibilities across geographically dispersed and diverse locations. Meanwhile, the need for quality communication with MNCs' stakeholders was suggested by Baaij, Mom, Van den Bosch and Volberda (2012) to be the main driver for moving functional divisions (including the internal audit function) abroad.

Against this background, it appears that considering the need to align internal audit practices with the local context, and the impact of internal audit on local resource endowments (and *vice versa*) holds benefits for a MNC. A geocentric approach, allowing autonomy to local internal audit units, could thus represent a value-enhancing approach for a MNC.

6.2 Global alignment

If internal auditing is represented outside the home location, it is essential that consistency of internal audit approaches and performance is maintained. Cicekli (2011) identifies three general management control mechanisms routinely applied by MNCs to ensure enterprise-wide convergence of objectives, values and behaviors: *centralization, formalization and socialization*. These could be equally beneficially adopted by MNCs' internal auditing functions.

As previously discussed, the practice of centralized decision-making is widely practiced by internal audit functions of MNCs. But *centralization* holds various disadvantages, as is widely acknowledged in the management literature: it may overload headquarters' decision-making capacity, adversely affect motivation and responsiveness at the division and subsidiary levels (Betts *et al* 2012:2; Cicekli 2011:177). Internal auditing researchers concur by emphasizing the benefits of allowing some local autonomy in decision-making processes (Moeller 2009:284; Barrett *et al* 2005:11; Liu *et al* 1997:470).

MNCs need to harmonize internal audit methodologies across all divisions and locations to secure coherent internal audit performance (Chan 1995:44). Common policies and procedures, toolkits, documentation and reporting standards represent the means of achieving *formalization.* Development of uniform internal audit procedures has numerous benefits, but may not be possible in all locations due to cultural disparities, unique regulatory requirements, and even different perspectives on what comprises the "necessary" implementation of the standardized policies and procedures (Barrett *et al* 2005:10; Chan 1995:44). Only 38 percent of respondents in an international internal audit survey conducted in 2010 indicated that internal audit was equally effective in all their enterprises' locations (Ernst & Young/Forbes Insight 2010:2), which illustrates the effect diversity of local environment has on the performance of an internal audit function. However, empirical studies also show that convergence could still be achieved through the development of common internal audit frameworks (Sarens & Abdolmohammadi 2011; Barett *et al* 2005; Chan 1995).

Acceptance and implementation of global standards is subject to effective communication of corporate objectives, values and behavioral patterns, which collectively constitute *socialization.* Business management literature provides an extensive list of mechanisms that can be used to ensure integration of strategy, goals and values, such as rotation, joint teamwork, and training programs amongst other activities, that promote informal interactions between dispersed locations (Miroshnik & Basu 2014:8; Cicekli 2011:177; Goodall & Roberts 2003:163; Milliman, Taylor & Czaplewski 2002:40). These techniques have already received the attention of internal audit professionals (Chambers & McDonald 2013; Protiviti 2012). Multinational organisations are already implementing rotation within internal audit departments (PwC 2012: 32; Baker 2010:1). Joint audits, where the audit team comprises internal auditors drawn from the MNC's different locations, provides a good opportunity to share knowledge and experience, as well as to develop team spirit and a better understanding of the organisation (Protiviti 2013). The MNC's intranet, which represents a platform for professional discussions among internal auditors from dispersed locations and is an effective tool of communication with internal audit's stakeholders, has also proved to be a viable option for alignment of values (Correia & De Faria 2004; Lee Kam Chung 2003).

Employment of various socialization mechanisms provides for effective two-way communication. The employment of common internal auditing policies and procedures throughout a MNC, if able to accommodate local nuances and experiences, can create valuable knowledge that is then incorporated into that MNC's global internal auditing standards. Integration and transfer of resources and competencies between geographically dispersed internal audit units epitomizes multidimensional heterarchical relationships that are typical of the geocentric approach.

7 CONCLUSION

It appears that ever-increasing global economic integration, along with the proliferation of MNCs, is creating opportunities for and driving the expansion of internal auditing functions into foreign locations. Internal auditing has to cross the borders out of the home country in order to cater for the evolving needs of its globally dispersed stakeholders, who require objective evaluations and opinions with regard to the diversified international activities of a MNC.

Internal auditing's development seems to resemble the evolution of MNCs, and to be encountering the same challenges, essentially stemming from the geographical dispersion of operations. In other words, internal audit needs to customize its methods to accommodate and address the diversity of local contexts it encounters, and to ensure its performance remains consistent and efficient. The parallels between MNCs' development and that of internal audit make theoretical frameworks and concepts, developed within the international business management research environment, equally applicable to the internal auditing functions of MNCs. Researchers have integrated agency theory, communication theory and institutional theory, and considered coercive, mimetic and normative pressures in their development of theoretical frameworks for the globalisation of internal auditing (Endaya & Hanefah 2013; Mihret *et al* 2010; Arena & Azzone 2007; Arena *et al* 2006; Al-Twaijry *et al* 2003).

Analysis of modern internal auditing trends indicates that there is a high level of complexity in internal audit environments, which originates from the psychic distance between different countries (where psychic distance is seen as the combination of cultural, administrative and economic distances between head office and those of the subsidiaries). The need for internal audit practices to be aligned with their local contexts, and the local knowledge that is frequently created as a result, constitutes a resource endowment for internal auditing functions that could be viewed as another way to add value to the global business. Geographical dispersion and the diversity of local contexts dictates the employment of mechanisms that ensure the enterprise-wide consistency of internal audit performance and the convergence of the objectives, values and behaviors of the MNC's internal auditing functions. The practice of centralized decision-making, formalization of processes and procedures, as well as their alignment with corporate objectives, values and behaviors through various means of socialization, seem to have already been adopted by MNCs' internal auditing functions. Given this background, a geocentric approach, which implies careful customization to recognise local context within established uniform standards, seems to be an appropriate framework for the internal audit function of a MNC.

This study aimed to address the gap in the academic literature on internal auditing in MNCs, and calls for further discussion and empirical examination of the phenomenon in the future. A literature review approach was followed, and based on previous studies in the field of international business management, a geocentric approach was identified as an appropriate structure for the internal audit function in a MNC. This implies the need for collaborative efforts on the part of the MNC's internal audit function to achieve global alignment of its internal audit practices through the development of uniform standards, determined by institutional business frameworks and the diverse resource endowments in different locations. Internal audit functions of MNCs are continually challenged to find the balance between global consistency and local responsiveness, a situation that is rich in new research directions. Future research could therefore identify influential variables and evaluate their impact on the level of autonomy needed and achieved by MNCs' local internal audit units, examine the relationship between local internal audit units and their effectiveness within the MNC's global internal audit functions, and investigate the allocation of responsibilities and resources among geographically dispersed internal audit units. Reviewing the various organisational approaches published in the international business management literature would strengthen the insights into, and offer a more comprehensive academic perspective and understanding of the global organization and coordination of internal auditing processes. The issues of internal auditing in MNCs should be further investigated in order to provide internal audit practitioners with additional (and more specifically appropriate) guidelines to help them cope with the complexities of combining global integration and local differentiation into a single internal audit methodology.

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Evolving Research

Integrated auditing – an internal audit perspective

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ABSTRACT

An integrated audit approach entails an intentional audit design process that cohesively combines business process auditing and information technology (IT) auditing into a single, co-ordinated effort. However, due to the continuing influence of longstanding methods of performing audits, the internal auditing fraternity has been slow to evolve, neglecting to train internal auditors who are confidently able to perform audits that combine both the business process audits and IT audits into one seamless audit. This study found that although holders of the Certified Internal Auditor qualification, and other members of the IIA are perceived to have mastered the theoretical knowledge provided by the CIA certification programme and other training courses, the manner in which they perform audits does not demonstrate the practical application of this knowledge.

Key words

Integrated auditing; business auditor; IT audit; CIA certification; application controls; general controls

1 INTRODUCTION AND BACKGROUND

Internal auditors performing business and information technology (IT) audits need to integrate their efforts because of the changing business environment (Chaney & Kim 2007; Brand & Sagett 2011). The changing business environment is manifesting as the increasing interconnectedness of processes and systems in business (Helpert & Lazarine 2009; IIA 2012a), and to gain a complete and holistic understanding of business risk, internal auditors also need to understand IT system risks (Jackson 2012; Helpert & Lazarine 2009; IIA 2012a). Integrated audit refers to an intentional audit design process that combines the auditing of business processes and IT systems into a single, cohesive and co-ordinated effort (Brand & Sagett 2011). This integrated internal audit results in a comprehensive assessment of the control environment that is far more informative than the more frequently presented collection of unconnected, compartmentalised views (Helpert & Lazarine 2009).

Therefore, the internal auditors tasked with both business and IT systems audits need to be groomed during tertiary education on how to conduct truly integrated audits. The curricula available to internal auditors should thus address the skills and expertise required to enable internal auditors to conduct integrated audits.

IT plays a fundamental role in the way modern organisations function. It has become integrated into business processes to the extent that virtually every type of audit requires some consideration of IT issues, and therefore all internal auditors should be familiar with IT's requirements (Abu-Musa 2008). Businesses are accelerating the expansion of their use of automated systems (Green, Best, Indulska & Rowlands 2005). A survey by Ernst & Young found that 72% of Irish-based organisations cite the implementation of IT systems as having central importance for their internal auditing (IA) activity (Ernst & Young 2014). This finding is supported in the results of the latest State of the Internal Audit Profession survey conducted by PwC, which identified eight foundational attributes of IA, one of which was familiarity with technology. However, a very low percentage of internal auditors are leveraging technology effectively in the execution of their audit services (PwC 2014). This was confirmed in the most recent Global Audit Committee survey conducted by KPMG, where it was found that although IA should be assessing technology, 50% of the respondents stated that internal auditors do not have the requisite skills and resources to perform these reviews (KPMG Audit Committee Institute 2014).

The effectiveness of internal auditing activities is improved by increasing the auditors' knowledge of technology (Abu-Musa 2008). The areas of internal auditing that can be improved in this regard include procedures followed in obtaining a sufficient understanding of accounting and internal control systems; consideration of inherent risk and control risk through which the internal auditor arrives at the risk assessment; design and performance of tests of control, and substantive procedures (Abu-Musa 2008).

Directors rely on internal auditors to educate them on the changing nature of IT risks, and the actions taken to mitigate them (IIA – Audit Executive Centre 2014). Audit committees and executive management rank IT as one of their top four priorities (KPMG Audit Committee Institute 2014). According to the IIA's research in the March 2014 Pulse of the Profession, boards of directors' levels of concern arising from cyber-security risks have reached 64% for the past two years. As a result, directors expect internal auditors to be more actively involved in the audit of technology (IIA – Audit Executive Centre 2014)), and this is consistent with the reponses to the KPMG Global Audit Committee survey (KPMG Audit Committee Institute 2014). Despite this, the same KPMG Global Audit Committee survey found that the quality of information about cyber-risk, technology and innovation provided to audit committees is inadequate. While the audit committees believe that the pace of change in technology poses one of the greatest challenges, this issue does not receive sufficient audit committee time or attention (KPMG Audit Committee Institute 2014).

The risks associated with not having the skills to audit IT applications arise from the fact that only certain controls are then able to be tested and certain frauds (particularly financial frauds), can escape detection (Smith 2012). Therefore, internal auditors need to be pro-active in assessing information security risks and incorporating them into the internal auditing plan (IIA – Audit Executive Centre 2014). In a study conducted by Brazel (2005), it was found that auditors who pro-actively assess information security risks are better able to recognise inherent and control risks. Also, auditors who perceived themselves to have high levels of systems expertise provided higher-quality risk assessments and planned more effective substantive tests. Thus, improved IT knowledge makes internal auditing more effective.

There is a low level of confidence among internal auditors about the quality and appropriateness of their IT training, resulting in a continuing reliance upon IT audit specialists, rather than on their own training (Kotb, Sangster & Henderson 2014). When internal auditors do conduct IT audits, they usually conduct two reviews, one performed by the business or general internal auditor and one by the IT (specialist) internal auditor; these are then collated into one report (Helpert & Lazarine 2009). This approach arises as a result of internal auditors believing that technology is the exclusive sphere of (specialist) IT internal auditors (IIA 2012a). This segregation of business and IT internal auditors also results in two audits of a single area, producing two unrelated reports addressing the same process, that then go to two different stakeholders. The IT audit report goes to IT department management and the business process internal audit report goes to the business' management (Brand & Sagett 2011). This lack of integration of efforts between IT specialist and business internal auditors also results in the audit being disconnected, and promotes a growing gap between what business internal auditors know of a process and the system that supports that process (Chaney & Kim 2007).

An integrated audit approach is not only required, as detailed below, but has become inevitable. It entails an intentional audit design process that cohesively combines business process auditing and IT auditing into a single, unified and co-ordinated effort (Brand & Sagett 2011).

The IIA Standards require internal auditors to assess the adequacy of IT governance, to determine whether it sustains and supports the organisation's strategies and goals (IIA 2013). In addition, the South African Treasury Regulations require internal auditors to evaluate the controls that have been established over the information systems environment (RSA 2005). The King Code on Corporate Governance concurs with this, stating that directors must ensure that prudent and reasonable steps are being taken with regard to IT governance (IoDSA 2009).

The following section assesses the skills that are needed to give internal auditors the confidence to audit a process by considering both its IT and busines process risks.

Specifically excluded from the scope of this paper are the tools that internal auditors use for auditing, like Audit Command Language (ACL) and Excel; the process of continuous auditing, and the use of audit documentation software like Teammate.

2 THE SKILLS NEEDED FOR AN INTEGRATED APPROACH

All internal auditors need to be able to evaluate all business process controls from end to end (Bellino, Wells, Hunt & Horwath 2009). IIA Standards require every internal auditor to be "aware" of IT risks and controls and to be proficient enough to determine if the implemented application controls have been appropriately designed, and are operating effectively enough to manage financial, operational and/or regulatory compliance risks (IIA 2012b).

The Public Oversight Board (2002) highlighted its concerns regarding the ability of internal auditors to properly assess risks arising from rapidly evolving information-processing systems. They encouraged internal auditors to expand their knowledge of new business-oriented information systems, and the associated risks and controls.

To become an internal auditor capable of designing and conducting an integrated audit, knowledge is needed of automated controls and of how to approach technology-based processes and risks (IIA 2012a). In addition, knowledge of general and IT application controls (which are controls over the IT environment), is required. This knowledge must include administration activities, and infrastructure and environment controls. Application controls apply to how the application processes information and passes it on to subsequent applications within the business system (Chaney & Kim 2007).

Internal auditors should understand how processes are automated and how applications enable information to flow through interfacing applications. The internal audit should be conducted by one unified team (albeit with diverse and complementary skill-sets) with shared objectives. In addition, the team's findings should be integrated into a unified report, addressing all aspects of the process (Helpert & Lazarine 2009), rather than appearing as individual reports issued by the internal auditors of the business and of the IT aspects of the entity. Internal Auditors must be able to convey the message to management about the risks that the organisation is facing across a process, for both manual and IT risks (Jackson 2012). However, in reality the majority of chief audit executives (CAEs) are short of internal auditors who have the requisite IT skills (Kinsella 2014).

The IIA's International Professional Practices Framework (IPPF) provides guidance on the competencies which internal auditors should demonstrate in order to be judged effective professionals, and goes further in requiring that this knowledge and the associated skills and other competencies are demonstrated in the performance of their responsibilities (IIA 2012b). However, the Standards also state that there is no expectation that all internal auditors have the expertise of an IT internal auditor (IIA 2012b). This statement does not reflect the current requirement, which is that internal auditors conduct integrated audits that cohesively combine business process auditing with IT auditing in a single, co-ordinated and coherent effort (Brand & Sagett 2011).

Plant, Coetzee, Fourie and Steyn (2013) assessed the basic level of competence that internal auditors should have in terms of the Internal Audit Competency Framework (IACF), the Institute of Internal Auditors' (SA) Professional Training Program (IIA PTP), and the International Professional Practices Framework (IPPF). None of these frameworks requires individual internal auditors to be independently competent in routine situations, nor were internal auditors expected to be independently competent in unique and complex situations, for example with regards to "IT framework tools and techniques".

It was found that "IT framework tools and techniques" was given a rating of "low level of competence required" by the South African higher education frameworks, and yet internal audit leaders perceive this set of competencies as demanding a "medium" rating (Plant *et al* 2013). In other words, internal auditing management requires internal auditors to be at least "competent" in their application of IT framework tools and techniques, despite their formal training having only given them a basic, "low" level of competence. This is confirmed by Chambers (2014) and Kinsella (2014), who both found that most internal auditing functions actually outsource their IT audit commitments because of the challenge posed by their function's lack of IT skills.

Fourie (2014) performed a study on the gap between the internal auditing profession's expectations of the university training and the skills actually possessed by recent internal auditing graduates. The study concluded that there is an expectation gap between the industry's requirements and the universities' apparent ability to deliver with respect to the technical and behavioural skill capabilities of internal auditing graduates. Simply put, universities in South Africa do not provide employers with internal auditing graduates who are fully work-ready.

Therefore, in summary, based on the above literature review, it is apparent that internal auditors should have the IT skills/knowledge to evaluate all business process application controls and general controls, and be aware of IT risks and the risks arising from the rapidly evolving information-processing systems. They also require knowledge of automated controls and an effective approach to the audit of technology-based processes and risks, and new business-oriented information systems' risks and controls. In addition they are expected to know how processes are automated, and how applications enable information to flow through interfacing applications.

3 WHAT SKILLS ARE CURRENTLY BEING TAUGHT TO INTERNAL AUDITORS

The Institute of Internal Auditors (IIA), as the profession's international representative, continues to be recognised for its key role in internal auditing education (Palmer, Ziegenfuss & Pinsker 2004). The IIA was incorporated on 10 November 1941 (Palmer *et al* 2004). During its first 50 years, the IIA grew dramatically, expanding from one chapter with 24 members in 1941, to over 2 000 members worldwide in 1991 (Van Peursem 2005). The growth has continued in the subsequent 25 years, with increasing numbers of internal auditors demonstrating their belief in the importance of professionalism as they strive to attain the Certified Internal Auditor (CIA) qualification (Van Peursem 2005).

In South Africa the IIA's premier certification, the CIA, is the final step in the theoretical aspect of the professional internal auditing career path (IIA 2014). The CIA designation indicates to employers that the internal auditor has a solid foundation of internal auditing knowledge, and the ability to apply that knowledge in the workplace. The CIA is awarded after three international exam papers have been passed with a minimum of 75% per paper. The entrance requirements for the CIA exam are that candidates have passed through the Internal Audit Technician or Professional Internal Auditor training programmes, or have been assessed as competent through a recognition of prior learning (RPL) process (IIA 2014). These options are normally offered through universities in South Africa.

There are aspects of the CIA course that students are required to be "proficient" at, and others where they need only demonstrate "awareness". Achieving "proficiency" means the candidate should have a thorough understanding of and ability to apply the concepts listed below, while "awareness" means the candidate has a grasp of the terminology and fundamentals of the concepts listed below (Gleim 2012-2013).

IT knowledge is tested in Part 3 of the CIA exam, mostly at the "awareness" level (Gleim 2012-2013). The syllabus is outlined below:

1 Control frameworks
2 Data and network communications/connections

3 Electronic funds transfer
4 e-Commerce
5 Electronic data interchange
6 Functional areas of IT operations (e.g., data centre operations)
7 Encryption
8 Information protection
9 Enterprise-wide resource planning (ERP) software
10 Operating systems
11 Application development
12 Voice communications
13 Contingency planning
14 Systems security
15 Databases
16 Software licensing
17 Web infrastructure

The CIA syllabus provides essentially “satisfactory” coverage of the knowledge and skills required for success in Part 3 of the examination (Gleim 2012-2013). However, in the Global Audit Committee survey conducted by KPMG it was found that, although internal auditors should be assessing technology, 50% of the respondents stated that their internal audit functions do not have the requisite skills and resources to perform these assessments (KPMG Audit Committee Institute 2014).

As universities in South Africa offering internal audit courses are preparing students for the CIA examination, the syllabi are therefore largely based on the CIA syllabus.

4 RESEARCH QUESTION

Therefore, the question arises:

Is the IT knowledge gained by internal auditors through the CIA certification and tertiary education programmes practically utilised when conducting business process audits that cannot be separated from the IT system?

The preceding sections provide evidence that IT audit resources are scarce, and that the internal audits currently being conducted are usually not integrated (i.e., there is an absence of an intentional audit design that would cohesively combine business process auditing and IT auditing into a single, co-ordinated effort). This situation is contrary to the current requirements of business, in that while the business process is intertwined with the IT systems, the audits of the business and IT aspects remain separate and singular.

The educational framework needs therefore to provide training of internal auditing graduates that enables them to conduct truly integrated audits.

5 RESEARCH OBJECTIVE

The research question forms the basis for the following research objective:

To determine whether the IT knowledge gained by internal auditors through the CIA certification programme and tertiary education is utilised in a manner that cohesively combines business process auditing and IT auditing into a single co-ordinated effort.

6 RESEARCH METHODOLOGY

The theoretical background presented in the previous sections was incorporated in the design of the research methodology and this is explained below. The objective of this section is to examine pertinent literature to describe and explain, with motivation, the research methodology applied in this research. In addition, the study’s research design, (a quantitative method was used to interrogate data the questionnaire generated) is explained and justified. The characteristics of the population from which the data was obtained are also described.

The research was based on a quantitative descriptive research method. This method was judged to be most effective for conducting a literature study to determine the status quo in the conduct of IT audits by internal auditors (including the requirements for internal auditors to conduct IT audits) and to compare this against the results obtained from the questionnaire emailed to IIA (SA) members.

A questionnaire was compiled and then pilot tested at the IIA (SA) Conference 2014 with five participants. The feedback from the participants was then used to amend the questionnaire. With the assistance of the IIA (SA), this final questionnaire was then e-mailed to all IIA (SA) members in the 2014 IIA (SA) database. These e-mails also contained an introductory letter and a letter of support from the IIA (SA), inviting participants to complete the questionnaire. A reminder was also sent out two weeks after the initial request. Respondents were required to e-mail their completed questionnaires directly to the researcher. Twenty-seven completed responses were finally received; the number of individuals contacted through the IIA was not formally disclosed, but anecdotal evidence places membership in excess of 500, meaning that the response rate was quite low. Recent research conducted found that the same conclusions would have been reached if data collection had been halted at earlier points in time. Therefore, the response rate is not predictive of a non-response bias (Meterko, Restuccia, Stolzmann, Mohr, Brennan, Glasgow & Kaboli 2015).

7 FINDINGS

The purpose of this section is to analyse, interpret, describe and meaningfully present the findings of the research, in order to determine whether the IT knowledge gained by internal auditors through the CIA certification programme and other tertiary education is being utilised in a manner that cohesively combines business process auditing and IT auditing into a single co-ordinated effort. The answers to the questions record the respondents’ perceptions in respect of the levels of IT audit skills demonstrated by their internal auditors. The questionnaire was sent to holders of the CIA qualification who are members of the IIA.

7.1 Questions 1 – 3 – Description of respondents

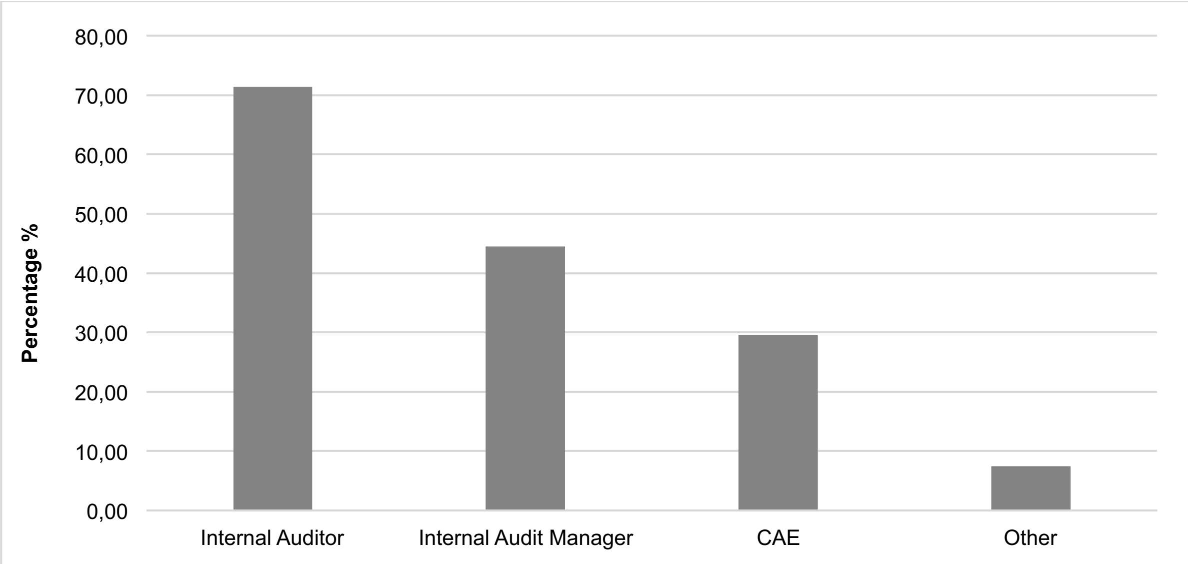
The researcher received twenty-seven completed responses directly from the survey respondents. The number of individuals contacted was not disclosed by the IIA, but the response rate can be assumed to be quite low. Survey respondents were separated into two groups, based on education.

Of the respondents, 68% hold the CIA certification and 32% a variety of other qualifications; and 70% are from the private sector while the remaining 30% are from the public sector.

The majority of the responses (44%) came from internal audit managers. The remaining respondents were chief audit executives (CAE) (30%), internal auditors (19%) and two (7%) respondents who had obtained the CIA certification but were no longer employed in the internal auditing field.

The first three questions were intended to identify the respondents by their position, education and whether they worked in the private or public sector. No correlation was drawn from the difference between private and public sector employment as the numbers were too small.

Figure 1: Percentage of respondents



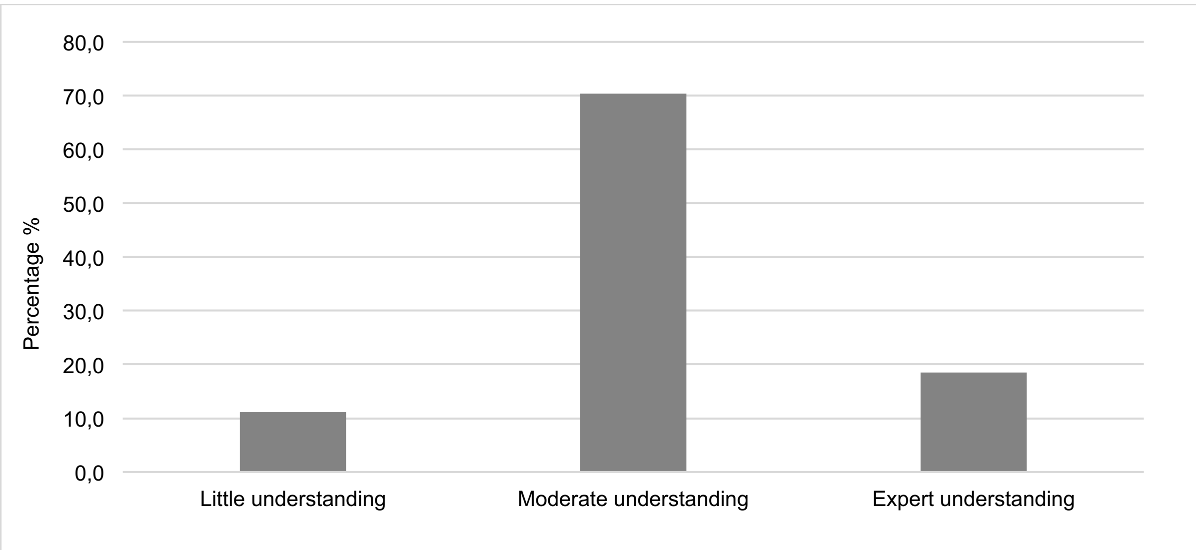
7.2 Interview responses

7.2.1 Question 4 – Understanding of integrated audits

Question 4 of the survey requested respondents to give an opinion on how well internal auditors within their audit activity understood the proposition that business processes cannot be separated from IT systems. The response is reflected in Figure 2 below.

The majority of the respondents have the perception that internal auditors have a moderate understanding that business processes cannot be separated from IT systems.

Figure 2: Perception of internal auditors that business processes cannot be separated from IT systems

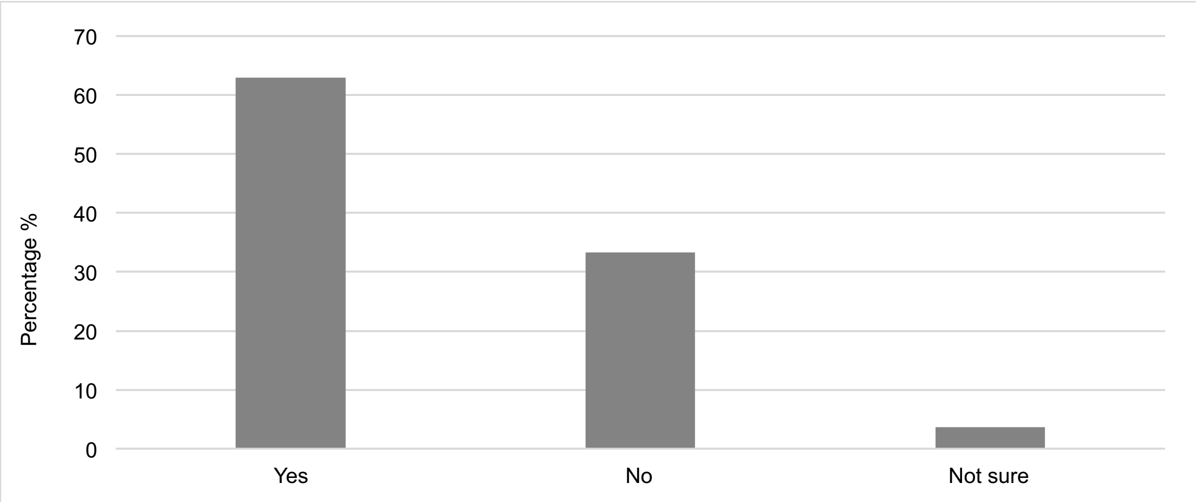


7.2.2 Question 5 and 6 – Specialist IT auditors and outsourcing of the IT audits

Question 5 sought to assess how many of the respondents have specialist IT auditors within their internal audit activity. Specialist IT auditors were defined in the questionnaire as being auditors who were familiar with and felt comfortable in auditing areas like security, electronic data engineering, business intelligence and data warehousing.

The majority – 63% of the respondents – stated that they have specialist IT auditors within the internal audit activity. However, this paper is aimed at assessing the application of knowledge of the non-IT specialist internal auditors. The fact that 63% of respondents indicate that their internal audit functions do have IT specialists might be an indication that for the rest of their team, their IT knowledge is low.

Figure 3: Does the internal audit activity have specialist IT auditors

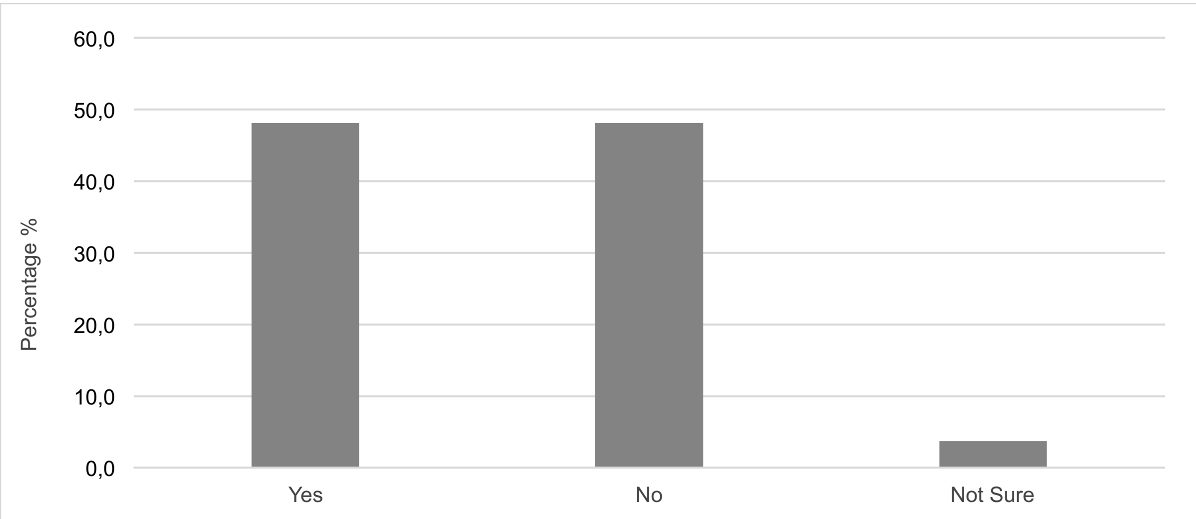


Question 6 asked whether the IT internal audit activity is outsourced. The analysis of this data was not used for this paper. Whether the internal audit activity is outsourced or not should not have a bearing on whether the internal auditors apply their IT knowledge. However, in the interests of completeness of the discussion of the survey results question 6 is recognised here.

7.2.3 Question 7 – Integrated audits performed

Question 7 is related to question 4 and requested respondents to give an opinion on whether internal auditors conduct audits that cohesively combine business process auditing and IT auditing into a single co-ordinated effort.

Figure 4: Extent to which business and IT audits are cohesively performed



There is an equal split between respondents who believe and those who don't believe that business audits and IT audits are cohesively combined into a single co-ordinated effort, as shown in Figure 4.

Conclusions drawn from responses to Questions 4 and 7:

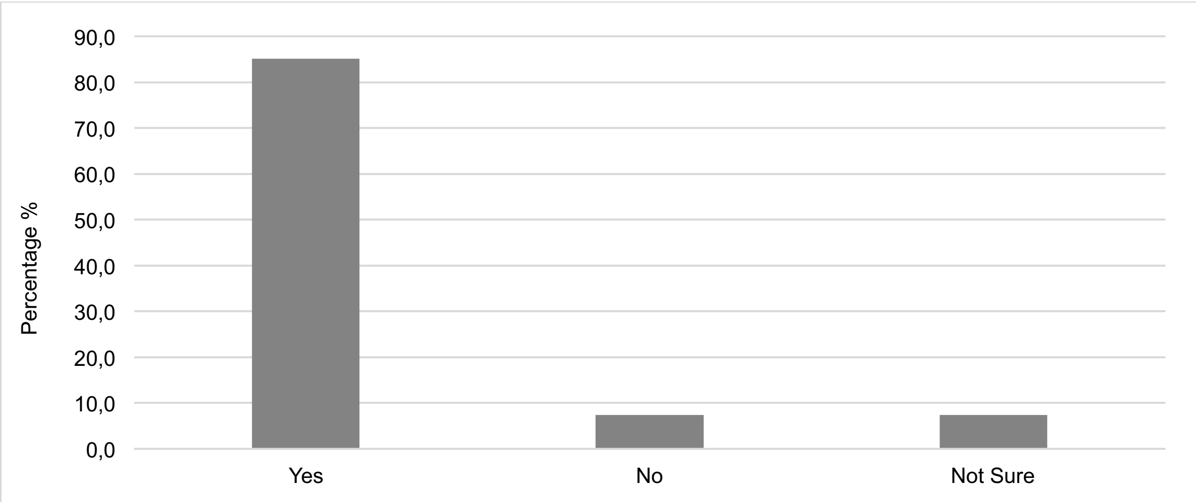
Question 4 sought to assess the perception of the respondents regarding the theoretical knowledge of their internal auditors - whether internal auditors were aware of the need to conduct integrated audits. The results show that the majority of the respondents believe that internal auditors are aware of this need; however, only 48% of the respondents stated that the audits of the business and of IT are performed as a cohesive whole by their internal auditors. This indicates that even though internal auditors have the theoretical knowledge that they need to conduct business and IT audits as a cohesive, single process, most of them are not doing so. The reasons for this were not specifically investigated, but probably include the situation that internal auditors do not know how to apply their theoretical knowledge, and/or that they have not yet been given the opportunity by the internal audit activity to perform such cohesive audits. This is an area for further research.

7.2.4 Question 8 – Understanding the difference between general and application controls

Question 8 sought to assess whether the internal auditors understood the difference between general controls and application controls. Since this question does not refer to the **demonstration** of this knowledge, it was assumed that the responses were based on internal auditors' theoretical understanding of the difference between general and application controls.

Figure 5 shows that the majority of responders (81%) believe that the internal auditors do understand the difference between general and application controls.

Figure 5: Understanding the difference between application and general controls

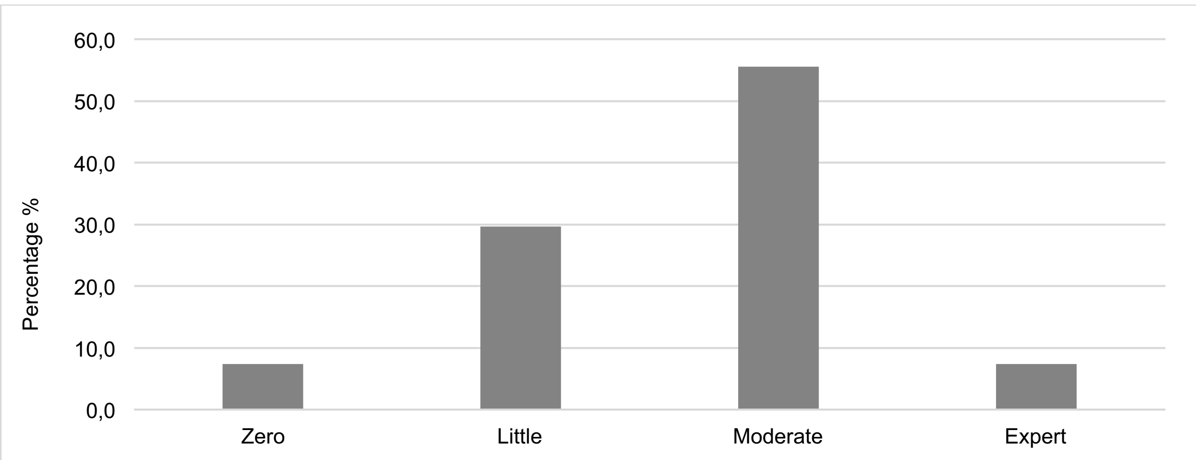


7.2.5 Question 9 – Ability to perform general controls testing

Question 9 assessed the respondent's perception regarding the statement that the internal auditors are able to perform general controls testing.

The perception of the majority of the respondents regarding the general controls testing ability of internal auditors was deemed to be moderate. However, 60% of this majority stated that the internal auditors do not conduct audits that cohesively combine business process auditing and IT auditing into a single co-ordinated effort. This implies that even though the internal auditors are able to perform general controls testing, in practice they do not utilise this knowledge (Figure 6).

Figure 6: Ability to perform general controls testing

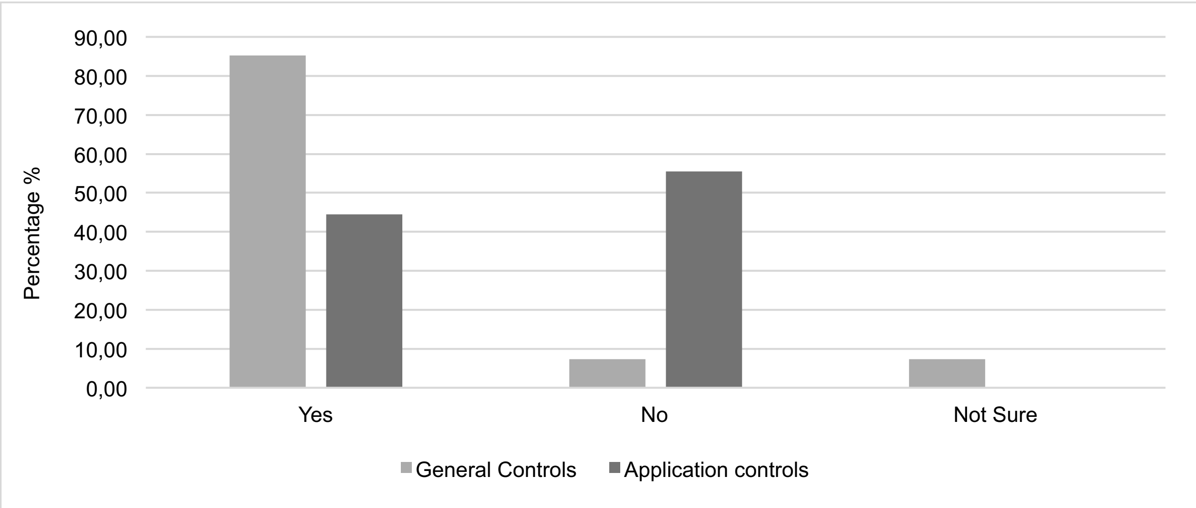


7.2.6 Question 10 – Comparison

Question 10 sought to determine whether the internal auditors understand the process for auditing application controls. Of the respondents, 41,7% said that internal auditors did not understand the process for auditing application controls (refer to Figure 7: Comparison of general and application controls knowledge, while44% of the respondents said that internal auditors did understand the process for auditing application controls. However, four of these latter respondents stated that they did not conduct audits that cohesively combined business process internal auditing and IT internal auditing into a single, co-ordinated effort; therefore, this could be referring to theoretical knowledge that is not applied.

There was also a greater number of internal auditors who understood general controls better than they did application controls, as reflected in Figure 7 below.

Figure 7: Comparison of general and application controls knowledge



Source: Conclusion drawn from responses to Questions 8, 9 and 10

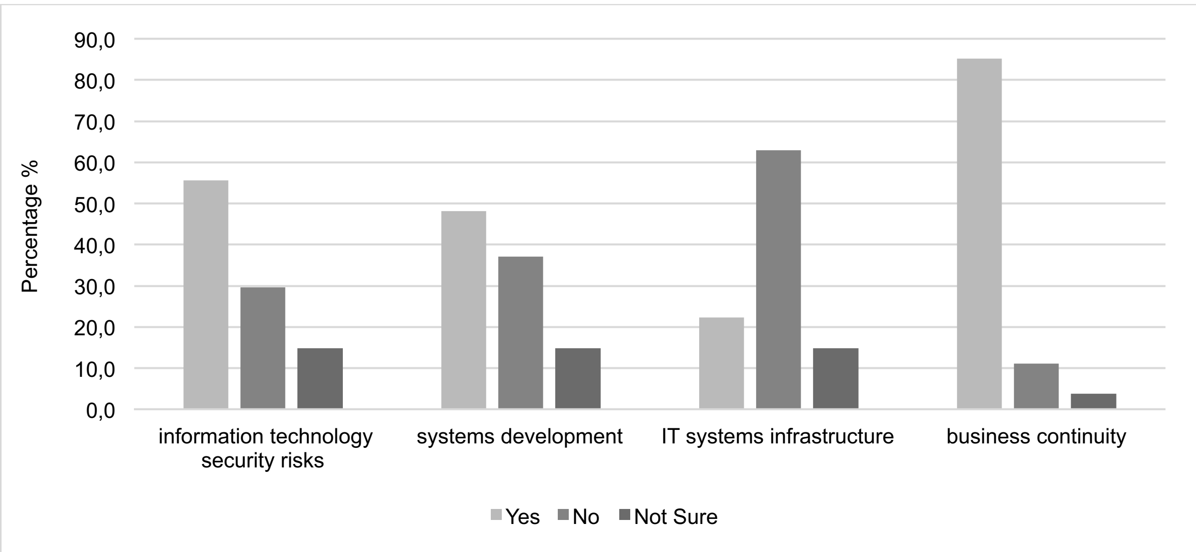
The results reflect that internal auditors have a greater knowledge of general IT controls than they do of application controls; however, these controls are not always tested by the internal auditors in practice.

7.2.7 Questions 11, 12, 13 – Knowledge of specific technical IT aspects

The remaining questions addressed IT security risks, systems development, and IT system infrastructure, and were intended to assess whether internal auditors practically demonstrate their knowledge of specific technical aspects of IT that are covered in Part 3 of the CIA syllabus or other tertiary institutions.

Figure 8 reflects that internal auditors have more knowledge of business continuity than they do of the other IT-specific areas. They have the least amount of knowledge in respect of IT systems infrastructure.

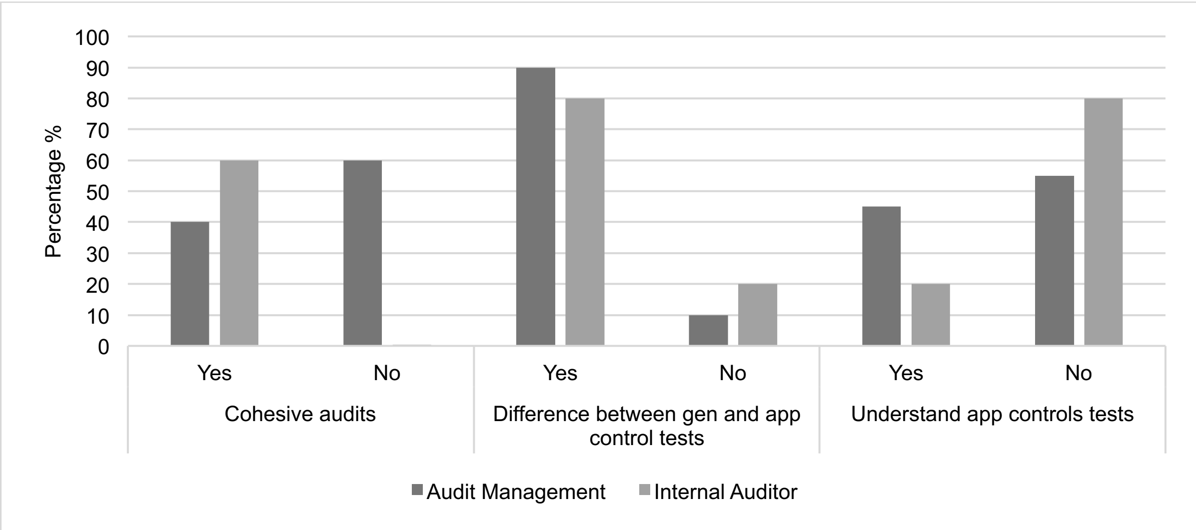
Figure 8: Internal auditors' knowledge in IT-specific areas



7.2.8 Management's assessment vs internal auditor's response

Management of the internal audit activity is taken to be the responsibility of the CAE and the internal audit manager. 20 of the respondents indicated that they were employed at an internal audit management level. Respondents who identified themselves as internal auditors were deemed to function at that level within their organisations. Participants were asked whether the internal audit activity conducts audits that cohesively combine business process auditing and IT auditing into a single, co-ordinated effort, and whether internal auditors understand the difference between general and application controls. An analysis of the response offered by management is compared with that of the internal auditors in Figure 9 below.

Figure 9: Audit management vs internal auditor perceptions



The audit management level is more confident than the internal auditor level that internal auditors understand the difference between general and application controls, and that they also understand application controls. However, audit management appears less confident that internal auditors can conduct audits that cohesively combine business process and IT auditing into a single, co-ordinated effort.

8 CONCLUSION

Based on the literature review, the IT skills needed by internal auditors included the ability to evaluate all business process controls, be aware of IT risks and controls and to understand application controls and the risks arising from rapidly evolving information processing systems. Other areas requiring IT skills included new business-oriented information systems' risks and controls; knowledge of automated controls and an approach to technology-based processes and risks; general IT controls; how processes are automated, and how applications enable information to flow through interfacing applications.

This study aimed to determine whether the IT knowledge gained by business and IT auditors through their participation in the CIA certification programmes and other IT training, is utilised in a manner that cohesively combines business process auditing and IT auditing into a single co-ordinated and cohesive effort. From the results of the survey, to which 27 IIA members responded, it can be concluded that the majority of the respondents were aware of the need to conduct integrated audits. However, only 48% of the respondents stated that business and IT audits are actually being performed in an integrated and unified manner. This reflects that even though internal auditors have the theoretical knowledge that they need to conduct business and IT audits as an integrated unit, they are mostly not doing this.

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A framework for internal auditors to assess ethics in a national public sector department

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ABSTRACT

This study proposes a framework that can be used by the internal audit function to assess the culture of ethical behaviour of South African national government departments. The limited number of published articles on the use of ethics frameworks in government, especially in the South African context, indicated a need for such a framework. A review of the literature on the culture of ethical behaviour, related governance frameworks, and the role of the internal audit function was conducted. Based on the literature, attributes for an ethics framework were identified and tested with three interviewees from one national department. The results of the study indicated that an ethics framework could assist the internal audit function in assessing an organisation's ethical culture and help management to enhance the organisation's ethical health.

Key words

Ethical culture; ethics framework; public sector; internal audit function

1 INTRODUCTION

The ethical culture in the South African public sector is fragile, which contributes to public officials behaving unethically. This fragility is evident in the adverse reports issued by the Auditor General, South Africa (AGSA), which highlight large numbers of irregular, and occurrences of fruitless and wasteful expenditure (AGSA 2014:61; AGSA 2015:48). The use of governance and ethics frameworks in the South African public sector is limited in that not all of those in place are enforceable, nor are they inclusive of an ethics management programme or process (as was recommended by the third *King Report on Governance for South Africa 2009* (King III) (IoDSA 2009b:19-22)). This limitation has created the need to develop an ethical framework, for use as standard best practice, in the public sector, with which to measure ethical performance and to enhance good governance. To measure ethics performance, management needs a trusted advisor, such as an internal auditor, who functions independently from organisational day-to-day operations (IIA 2010:33; IoDSA 2009a:80; NT 2009:25). One of the fiduciary duties of the internal audit function is to assess and identify gaps and areas in an organisation's ethical framework that need improvement (IIA 2012b: 11; IoDSA 2009a:8-9). Global research, conducted specifically in the field of internal auditing, suggests that internal audit should be assisting management to build within organisations a culture of compliance that is inclusive of ethical standards (Elmore 2013:51-52; IIA 2012a:1; IIA 2012b:11; NT 2009:51-52).

There is limited guidance for management in the South African public sector on how to build an ethical culture within their organisations. King III was issued in 2009, but only introduced to the public sector for implementation in 2010, which then opened up discussions on governance in government (PwC 2010). King III operates on an "apply or explain" basis and emphasises that the executive management is responsible for the following: building and sustaining an ethical culture, including the identification of ethics risks (PwC 2010:8; IoDSA 2009b:5-6); the implementation of a code of ethics and related policies (Irwin 2011:11), and the assessment of ethics performance (PwC 2010:8). In addition to King III, the Department of Public Administration published a Public Sector Integrity Management Framework in 2011 (DPSA 2011) and the Public Administration and Management Act (SA 11/2014) was passed in 2014, in which the need to effectively manage ethics within the public sector was highlighted. Earlier efforts by government to guide the behaviour of public sector officials include the Public Finance Management Act (1/1999), the Municipal Finance Management Act (56/2003), and the Public Service Regulations (2001). However, with specific reference to formal ethics management processes, it appears that these acts are fragmented and unstructured.

Establishing an ethical culture in a public sector organisation is an important leadership function, which should be dealt with by the head of a department (executing authority/accounting officer) as per section 3 of the Public Service Act (103/1994). In addition, all employees within the South African public administration are responsible for promoting and maintaining a high standard of professional ethics (SA 1996:74). According to the Auditor General, South Africa, the leadership at national, provincial, and local government levels is failing government by not acting against perpetrators of unethical behaviour (AGSA 2014:32; AGSA 2015:9). Such behaviour points towards the need for guidance to assess and monitor ethics performance.

This study addresses the following question: What framework can be used by the internal audit function within the South African public sector to assess the ethical culture of the organisation? To answer this question, this article is structured as follows: firstly, it details the research objectives, the methodology used, and the limitations thereof. The next section contains a literature review, followed by the results of the empirical part of the study. Finally, the conclusions reached on using the proposed ethics framework to assess ethics performance within the South African public sector are provided.

2 RESEARCH OBJECTIVES, SCOPE, METHODOLOGY AND LIMITATIONS

The aim of this study is to propose a framework that can be used by internal auditors to assess the ethical culture in South African national public sector departments.

Currently, no scientific research focusing on the development of an ethical framework for the South African public sector has been conducted. This study is an attempt to assist departments and scholars in the South African national public sector to develop such a framework. In order to arrive at an alternative policy imperative for the South African national public sector departments, a review of the literature, as it relates to ethical culture in the South African public sector, was conducted. The literature study was conducted to understand the concepts of ethical culture and governance of ethics, and a comparison was then made between legislative frameworks and guidance relevant to the development of an organisation-specific ethical culture. Furthermore, a comparison was made between two maturity models to identify relevant ethics attributes. The empirical research carried out for this article took the form of a case study, which involved semi-structured interviews with two senior members of the executive management of a national South African public sector department, namely the chief audit executive (CAE) and the chief risk officer (CRO), and the audit committee chairperson of that national department. The purpose of these discussions was to obtain input regarding the acceptability of the proposed ethical framework (discussed in Table 3) and to determine whether it can be used by internal auditors to assess the ethical culture of public sector organisations in South Africa.

The department that was selected to be the subject of the study has already been recognised for its strong pillars of governance, as reflected in its most recent annual report. These pillars are: risk management; fraud and corruption management; conflict of interest minimisation; the presence of a code of conduct; the presence of an internal control function; the presence of an internal audit function, and the presence of an audit committee. In addition, the department has designated mid-November to mid-December as their annual anti-corruption period, during which staff are made specifically aware of fraud and corruption issues, and are provided with opportunities to promote ethical conduct. Furthermore, the department has a strong control environment in that no instances of fraud/corruption were reported during the 2013/2014 financial year. The interviewees were selected based on their respective roles in governance and ethics. The audit committee is an independent oversight structure with the responsibility of ensuring that all activities relating to internal control, risk management, and governance are co-ordinated through a combined assurance model (IoDSA 2009b:52-53). Management is regarded as the first line of defence; risk management as the second line of defence and provider of internal assurance; and lastly, the internal audit function is regarded as the third line of defence and an independent assurance service provider (Dinga 2012:16-17). The linkage between the key role players in the assurance model is clear and provides sufficient reason for the inclusion of these participants in the empirical study.

The data collected from the individual interviews were analysed and interpreted to determine the acceptability of the proposed ethics framework as a tool to guide the internal audit function and other role-players in assessing the ethical culture within the organisation.

The limitations of this study include the fact that only South African legislative frameworks and guidance were studied, and that only one national department participated in the study. In line with the limitations of a case study, the findings of the study cannot be generalised (Creswell 2009). However, the results of this study will enhance the ability of internal audit practitioners in the South African public sector to assess the ethical culture of their organisations. Management of public-sector departments can also benefit from the findings of the study by applying the standard framework to build an ethical culture, thereby improving and strengthening the governance and ethical health of their organisations.

3 LITERATURE REVIEW

3.1 Introduction

The literature review consists of three sections: firstly, the concepts of ethical culture and governance of ethics are considered; secondly, a comparison is made between available legislative frameworks relating to the governance of ethics within the public sector, and lastly, published ethics maturity models are compared to identify attributes that can be used by internal audit to assess ethics.

3.2 Ethical Culture

Rossouw and Van Vuuren (2013:305-306) define ethical culture as "an interdependent, interrelated dimension of the broader organisational culture".

Fallon and Butterfield (2005:397) are of the view that an ethical culture influences behaviour and subsequently promotes ethical decision making. Treviño (1986:601) and Kaptein (2011:844) support the view that ethical culture influences behaviour, but also highlight that it pertains to those aspects of an organisational context that obstruct unethical behaviour and encourage ethical behaviour. Rossouw and Van Vuuren (2013: 305-306) and Ardichvili, Mitchell and Jondle (2009: 445) indicate that an ethical culture is comprised of formal and informal components. The formal component involves visible and measurable aspects of an organisation's structures, such as rules, codes of ethics, policies, disciplinary procedures, and ethics management structures (Rossouw & Van Vuuren 2013: 306). Ardichvili *et al* (2009:446) assert that a good ethical culture should be characterised by a structure that allows for shared distribution of authority and accountability, as well as a clear code of conduct that is well communicated, understood and enforced.

Ethical culture also includes informal components, such as organisational stories, traditions and informal practices (Rossouw & Van Vuuren 2013:305-306). In addition, Brown and Treviño (2006:601) highlight that informal systems include other aspects, such as values demonstrated by role models, norms and standards displayed through socialised informal processes, daily behavioural norms and the existence of sub-cultures, organisational rituals and behavioural criteria used to issue awards, organisational stories relating to promotions and resignations, and whether discussions of ethical concerns are open or closed. Brown and Treviño (2006:601) assert that these informal aspects, which they refer to as the "deep culture" of an organisation, are not easy to understand or measure; thus the development of an ethics framework for the public sector will assist management to be aware of the attributes that impact the organisation's ethical culture.

The Global Institute for Ethics (2014) identified specific universal ethical values which transcend all religions and cultures. These values comprise "trustworthiness, responsibility, respect, compassion and fairness". It is implied that these values are embraced by most organisations globally and form part of good governance. This view is supported by the Institute for Local Government (ILG 2009:4).

Building an ethical culture requires that one also understands the underlying challenges that may hamper the process. Amundsen and De Andrade (2009:6) caution management to be aware of the reasons why staff may not value ethics. These reasons may include employees' belief that ethical behaviour consists solely of compliance with all set rules and policies, and that staff do not always like to be told what to do or not to do (Amundsen & De Andrade 2009:6). In addition to this, unethical behaviour by staff may also be the result of influence or pressure, exerted by a higher authority, to take decisions that are unethical, or not in the best interest of the public (Amundsen & De Andrade 2009:6). Decisions made by public officials sometimes create an ethical dilemma, in that a person may be forced to choose between fulfilling the mandate of their position and exposing him/herself to the risk of jeopardising his or her position or a valued relationship (Amundsen & De Andrade 2009:11; ILG 2009:9). In the eyes of the public, a government official is regarded as a trustee of the state coffers and is thus expected to act professionally and with integrity (Landman 2011).

Schoeman (2012:14) highlights that political leaders in South Africa are not held accountable for unethical behaviour; in the event that misconduct is proved. Instead of being disciplined, they are transferred to another position, (temporarily) out of the spotlight. The message thus being communicated to public officials, and to society at large, is that it is acceptable to place your own interests above those of others. Unethical behaviour by people in senior positions is rationalised by referring to the wrongs of the past, or by proclaiming self-entitlement (Schoeman 2012:14). Schoeman (2012:14) is also of the view that the behaviour of leaders can be influenced by group values, rules and culture, but that their fellow leaders should also play an active role in influencing them to behave ethically.

The Auditor General South Africa (AGSA) (2014:32; 2015:9), in its latest audit reports, proclaims that the minimum actions requiring effective and appropriate disciplinary steps as prescribed by legislation were not instituted against officials involved in transgressions relating to irregular, fruitless and wasteful expenditure at national, provincial, and local government levels. Failure by leadership to act in this regard creates the perception that this kind of behaviour is acceptable and tolerated. According to Rossouw (2014), "too many of our public servants abuse their positions for self-enrichment." To remedy this phenomenon, the focus should change from self-interest to servicing the needs of the public. Public officials are also part of society at large and should play a part in building a culture of ethics (Rossouw 2014).

It is apparent from the literature that public sector departments in South Africa are faced with various ethical challenges for different reasons. Leadership should take ownership of the challenges and implement measures to bring about ethical behaviour.

3.3 Ethics management

Ethics management refers to the pro-active management of ethics within an organisation in order to build an ethical culture (EthicsSA 2014), which is regarded as a cornerstone of good governance (IoD 2009b; IIA 2012a:1). A robust ethics management programme that defines ethical behaviour and sets (and takes its lead from) the "tone at top" is needed (IIA 2012a:1). These programmes must have senior management involvement, organisation-wide commitment, and a customised code of conduct. Ethics management programmes must also provide a framework for investigating reported incidents, taking disciplinary action against offenders, providing ethics training, and organisation-wide communications with staff on ethical matters. Ongoing monitoring systems and an anonymous incident-reporting system are further essential components of any such programme (Deloitte & Touche 2014:4; IIA 2012a:1). Sheeder (2005:35) describes the "tone at the top" as an organisation's "integrity DNA", which means it influences everything the organisation does. If management does not provide a positive example of the importance of integrity and of doing the right thing, then not even the best control or compliance programme will prevent unethical behaviour (Sheeder 2005:35; Kranacher 2006:80).

Rossouw and Van Vuuren (2013:138), Protiviti (2012: 1) assert that ethical culture is strong in organisations where employees perceive management to be serious about ethics and where their actions complement their words and the entity's stated values. Management should establish ethical values in the form of a mission statement, a vision statement, and a code of conduct, as these can be used to influence staff behaviour and define goals (Protiviti 2012:1-2). If these values are not implemented in practice, via a formal ethics management programme, then the organisation's ethical culture will be superficial at best, which will result in organisational dysfunction and operational ineffectiveness (Jondle, Maines, Burke & Young 2011:35). Kavanagh (2010:8) proposes that peer support for efforts to comply with ethical standards will drive down rates of financial misconduct.

To promote a sound ethical culture in the public sector, management should be seen to be applying some basic ethical principles which are regarded as best practice in government (Institute for Local Government (ILG) 2009:13-24). These principles require management to lead by example, by demonstrating the right attitude and behaviour; setting mission and vision statements that include values which portray management's commitment to ethics; issuing a value-based code of ethics that highlights the ethical principles of respect and fairness, and by conveying a consistent message about how things are done in an ethical manner (ILG 2009:13-24). Other ethics strategies to consider for an ethics management programme include: the recruitment of staff with the right attitude towards public service; performing background and reference checks; launching an ethics campaign to promote the ethical values of the organisation; implementing strong control policies to regulate employment, procurement, and finance; educating new recruits about ethical values as part of induction programmes; including ethics-related issues as part of employee performance assessments; discussing ethical issues at staff and organisational meetings, and conducting ethics audits to determine the actual ethical culture of the organisation (ILG 2009:13-24). While an organisation can implement all these principles to avoid scandals, in order to gain the public's trust, management must demonstrate by their actions their commitment to these principles (Kranacher 2006:80).

Challenges in the public sector relating to the governance of ethics can be managed through a comprehensive governance framework and management process, which includes elements such as leadership commitment and governance structures (IoDSA 2009b:19-22; Rossouw & Van Vuuren 2013:217-237; PwC 2010:6-8; Treviño & Brown 2004:80). Furthermore, the framework should include an ethics risk profiling component to mitigate risks such as political appointments, positional power, and conflicts of interest (Rossouw & Van Vuuren 2013:236-238; IoDSA 2009b:20; Amundsen & De Andrade 2009:28-39). In addition, the framework should also include a code of conduct and related policies, promote the institutionalisation of ethics, and provide mechanisms for the assessment, monitoring, reporting and disclosure of ethics performance (IoDSA 2009b:20-22; Rossouw & Van Vuuren 2013:272-299).

3.4 Legislative frameworks and guidelines: a comparison

To determine whether ethics management in the South African public sector context makes use of adequate governance frameworks, a comparison was made between King III (Chapter 1 principle 1.3), the Public Sector Integrity Management Framework, the Public Service Regulations (Chapter 2), and the Public Administration Management Act (chapter 6) (this act is not yet in operation), as shown in Table 1 (DPSA 2011; DPSA 2012; SA 2014). The aforementioned sources of guidance were preferred because legislation such as the PFMA, the MFMA, and Treasury Regulations mostly address vulnerability within the financial environment or areas with material risks. The fragmented nature of these pieces of legislation makes it difficult to use them effectively to manage ethics and build an ethical culture, as most of these legislative frameworks focus on issues related either to finance or to supply chain management, with an emphasis on preventing and/or discovering financial misconduct (National Treasury 2005; SA 1999; SA 2003).

As a point of departure, the elements of the King III Report focusing on the governance of ethics are used to assess the adequacy of the other frameworks used by South African public sector departments for guidance on building a culture of ethical behaviour (IoDSA 2009b:20-22). King III emphasises the importance of ethical leadership and the effective governance of ethics, which is comprised of the following components: identifying ethics risks; developing codes of ethics; institutionalising these codes, and assessing and reporting on ethics performance (IoDSA 2009b:20-22; PwC 2010:2-3). The Integrity Management Framework has been developed for the South African public sector and aims to strengthen the measures and standards used for managing integrity, promoting ethical conduct and managing unethical behaviour (DPSA 2011:4). Public Service Regulations (DPSA 2012:46) give effect to the Constitution by providing public officials with guidelines in the form of a code of conduct outlining how to behave ethically, in order to promote professionalism. Furthermore, the Public Administration Management Act (11/2014) calls for the establishment of a public administration ethics, integrity and disciplinary technical assistance unit within every public sector organisation, which should take responsibility for management ethics (SA 2014:17). The said regulations and codes of conduct on their own do not constitute or promote good governance; in efforts to strengthen the ethical standing of those generating "the tone at the top", government also requires an ethical leadership foundation, as suggested by King III (IoDSA 2009b:16). In addition, the Department of Public Service and Administration

(DPSA 2011:3) emphasizes the importance of ethics, defining it as "well based standards of right and wrong that prescribe our rights, obligations and benefits to society. Ethics is about how we ought to live, treat others, run or manage our lives and organisations".

Summary

The results of the comparison of the four governance frameworks available to South African public sector institutions, as set out in Table 1, raise some concerns. Based on the comparison, the Public Sector Integrity Management Framework, the Public Service Regulations (PSR) and the Public Administration Management Act (PAMA) only make reference to "a code of conduct", whereas King III highlights all the elements of a formal ethics management programme. Furthermore, the Public Sector Integrity Management Framework, the PSR, and the PAMA are prescriptive frameworks which are strongly focused on compliance with laws and regulations. Although both the Public Sector Integrity Management Framework and the PAMA imply the management or governance of integrity and ethics, these frameworks provide limited guidance on the specific characteristics of any such ethics management programme or process.

Table 1: Public Sector governance frameworks: South African perspective

Elements of governance of ethics	Frameworks			
	King III	Public Sector Integrity Management Framework	Public Service Regulations (PSR)	Public Administration Management Act (PAMA)
Ethics risk profiling	Management should assess ethics risks and develop a risk profile.	The importance of a risk management system is emphasised, but there is no specific reference to ethics.	The PSR is silent about how ethics risks should be managed.	The PAMA is silent about how ethics risks should be managed.
Code of Conduct	Management should implement ethical standards, in the form of a code or policy, to control negative ethics risks.	Code of conduct provides direction on managing staff performance (including supply chain practitioners), relationships with the public and between staff, personal conduct and private interests. Code of conduct includes standards, with restrictions relating to the acceptance of gifts/other benefits, disclosure of financial interest and assets, and remuneration for work outside the public sector. Framework outlines the legislation for managing corruption, namely the Public Service anti-corruption strategy, Local Government anti-corruption strategy, Corruption Act No.94 of 1992, and Prevention and Combating of Corrupt Activities Act No.12 of 2004.	The PSR outlines the expectation that staff at senior manager level will maintain a high level of professionalism and integrity and will avoid issues of conflict of interest. The PSR includes a code of conduct that describes how staff should behave, perform their duties, disclose private interests, and maintain good relations with the public, other employees, legislature, and executive authority. It also highlights the responsibility to report fraud/corruption.	The PAMA states that an ethics, integrity, and disciplinary technical assistance unit should take responsibility for developing standards and norms of conduct, ethics and discipline.
Institution-alisation of ethics	Management should ensure that the ethical standards are integrated into all strategies and operations. This should include management practices (employee screening, training, disciplinary and reward systems) and structures (ethics committee, ethics function, and ethics champion).	The framework is silent about how ethics should be integrated into strategies and operations. It only makes mention of the appointment of an ethics champion in terms of the minimum anti-corruption standards.	The PSR is silent about how ethics should be integrated into strategies and operations.	The PAMA is silent about how ethics should be integrated into strategies and operations.
Assessment, monitoring, reporting and disclosure of ethics	Management should ensure that its ethics performance is assessed, monitored, reported and disclosed. Internal and external assessments are needed to provide assurance to management and external stakeholders about the quality of ethics performance.	The framework does not make reference to the assessment, monitoring, reporting and disclosure of ethics. However, it does highlight the importance of monitoring its implementation by the Anti-corruption unit, and reporting thereon to the Minister of Public Service and Administration.	The PSR is silent about how ethics performance should be assessed, monitored, reported and disclosed.	The PAMA highlights the importance of reporting misconduct, but is silent about how ethics performance should be assessed, monitored, reported and disclosed.

Sources: IoDSA (2009b:20-22); DPSA (2011); DPSA (2012); PwC (2010); DPSA (2014)

Emerging from this comparison, it appears that the public service frameworks merely insist on compliance, and otherwise fail to provide detailed guidance on effectively managing ethics and building a culture of ethical behaviour. It is therefore evident that to build a culture of ethical behaviour, national public sector departments have to combine the public sector frameworks together with the recommendations made in King III (as King III is applicable to all South African entities, including those within the public sector (IoDSA 2009b:13).

3.5 Towards developing an ethics framework

As indicated above, the frameworks studied in Table 1 seem to provide limited guidance to the internal audit function to assess ethics within the South African public sector. To remedy this shortcoming, and for the purposes of this study, two available ethics maturity models were studied (their key characteristics are reflected in Table 2). A maturity model is a matrix tool that describes the characteristics of specific attributes at distinct levels or stages of maturity (Paulk 2009:5-19). The intention of this study is not to develop a new maturity model, but rather to propose a framework using existing and presumably familiar models, that can be used by internal auditors to assess ethical culture. The proposed framework must be able to provide guidance on the assessment of ethics to internal audit functions in government (NT 2009:2-3).

The IIA (2013:2) states that an appropriately-developed maturity model can serve as a framework in which to assess ethics. It also highlights that a maturity model describes the "as is" state of a process, and can therefore be used to identify areas of improvement and forecast the likely outcomes of the organisation's processes (IIA 2013:2). Wilkinson and Plant (2012:22) are of the view that a maturity model is a suitable tool to identify and assess levels of maturity in a governance environment, including that of an organisation's ethical culture.

Kaptein (2008:924-927) and the IIA (IIA 2012a:4-5) are in agreement that the ethical culture of an organisation is only effective if it reaches the stage of "maturity". "Maturity" is characterised by attributes such as: a clear and understandable formal code of conduct; frequent communication of expected ethical attitudes and behaviour; fair treatment of, and displaying trust in, staff; strategies and programmes to support the organisation's ethical culture; compensation practices that do not inadvertently encourage "bending the rules" to achieve performance targets; confidential channels through which to report suspected violations of the code of conduct, policies, and other acts of misconduct (whistleblowing systems), and appropriate punishments for unethical behaviour, regardless of the perpetrator (i.e., no exceptions are made) (Kaptein 2008:927).

According to the literature survey conducted for this study, only two ethics-related maturity models (those described by the IIA and by Rossouw and Van Vuuren), were found to relate closely to the culture of public sector institutions in South Africa (IIA 2012a:13-18; Rossouw & Van Vuuren 2013:58). Rossouw and Van Vuuren (2013:58) describe the Modes of Managing Morality (MMM) model, a South African-based maturity model, while the IIA's Maturity Model forms part of a practice guide on assessing ethical culture that is available to internal auditors globally. It appears that these two maturity models have similar modes of maturity but different attributes, as indicated by a study conducted by Wilkinson and Plant (2012:19-31) in which a governance maturity framework for use by internal auditors was proposed. The two maturity models and the public sector governance frameworks were compared in order to facilitate the identification of the relevant attributes of such instruments (see Table 2). Once identified, these attributes were used in the construction of a framework proposed for use by internal auditors in assessing ethics. This proposed framework was used as the basis of discussion during empirical research conducted at a national public sector department.

Table 2: Comparison of ethics-related maturity models

Model	Attributes	Modes of Maturity				
		Immature	Repeatable	Defined	Mature	World-class
IIA Maturity Model	Code of Ethics	No formal code to communicate management expectations.	Formal code may be outdated and not explained to new staff.	Code is reviewed every two to three years and signed annually by all employees, including new ones, as evidence that they understand it and agree to comply.	Code is reviewed annually and staff complete questionnaires relating to its compliance.	Policies are in place to provide additional guidance, and periodic surveys are done to assess overall compliance with ethics codes and policies.
	Culture and consistency	Inconsistencies in disciplining non-compliance with the code and the application thereof.	Perception exists that compliance is vital, but it does not form part of job descriptions and cases of misconduct are not pre-emptively reported.	Perception exists that management takes ethics seriously and disciplinary steps in collaboration with Human Resources are taken in cases of non-compliance. Ethics form part of job descriptions and staff ask questions to avoid inadvertent non-compliance.	Ethics is a standing agenda item at organisational/ departmental meetings. Ethics are formalised in job descriptions and form part of interviews. Staff feel empowered to ask questions about compliance.	Periodic surveys are performed to determine perceived levels of compliance. Inputs are solicited from employees to improve the programme and to reward good ethical behaviour.

continued/

Model	Attributes	Modes of Maturity				
		Immature	Repeatable	Defined	Mature	World-class
	Awareness	Employees are aware of the existence of the programme, but not its requirements or where or from whom one obtains information.	Employees are aware of the existence of the programme, attended training, know some of the requirements and who the compliance officer is.	Organisation-wide awareness of the programme, and all staff have been trained within the past three years. Staff know who the compliance and risk officers are.	In-depth annual training; staff understand the expectations and are compliant. Ethical issues are included in supplier contracts.	Regular communications remind staff of programme expectations, and the programme forms part of sustainability reporting.
	Structure and account-ability	There is no formal compliance structure or no oversight body; accountability is not defined; investigations are done on an ad-hoc basis, and compliance risks are not understood.	A designated compliance officer has been appointed, albeit with no clearly defined responsibilities. Oversight and monitoring is done inconsistently and reactively. Investigations are done by appropriate staff. Accountability and compliance risks are understood, but not formalised.	A formal structure is established; responsibility is allocated to risk officers; oversight is defined from a management perspective; monitoring is established in liaison with internal audit; investigations are done and compliance risks are documented.	Timely and consistent reporting by risk officers to compliance manager; quarterly reporting to oversight body on compliance issues; internal audit plan includes compliance risks; formal compliance risk assessment is performed, and a formal protocol/ guideline exists for investigations.	Developed and implemented an integrated monitoring plan in conjunction with compliance manager, risk officer and internal audit. Sensitive investigations are performed by staff trained in forensic and investigation techniques. Programmes are updated annually in line with new risk scenarios.
	Process, automation and integration	There are no formal compliance controls or procedures to guide staff or outsiders in reporting issues of non-compliance, and no data on issues of compliance are available.	Some compliance controls or procedures exist, but are not consistent or formalised. There is limited testing of controls. Staff are aware of who to contact to report issues of non-compliance. It is difficult to compile data on events of non-compliance.	Compliance controls or procedures are well documented, standardised and tested periodically. A Hotline exists for reporting non-compliance issues; some compliance controls are integrated into business processes and some standard reports are compiled for issues of non-compliance.	Compliance controls or procedures form an integral part of business processes; many compliance controls address key risks from a Governance, Risk and Compliance (GRC) perspective. There are multiple avenues for reporting issues of non-compliance. A plan has been developed to test whether controls/procedures operate effectively and technology is used to identify and investigate compliance events.	An integrated GRC programme has been established to ensure compliance risks are aligned with the organisation's risk appetite. Data Event software is used to keep records of data gathered, and analysed. GRC software is used to generate integrated data on events and to run routine technology applications to prevent and detect potential compliance events.
	Goals and measure-ments	No formal goals or measurements	No formal goals or measure-ments, but staff do understand that the absence of compliance events is indicative of a successful programme.	Broad compliance goals are established and communicated. Measurements of the nature and frequency of compliance events are performed.	Specific compliance goals and measurements are established for each risk area.	There are established compliance goals for all employees. Measurements are integrated into the overall performance measurement process.
Model	**Attributes**	**Immoral mode**	**Reactive mode**	**Compliance mode**	**Integrity Mode**	**Totally aligned organisation (TAO) mode**
Modes of Managing Morality (MMM) model	Ethics managemen t strategy	No ethics strategy or interventions	Ethical values are not enforced or implemented.	Systems and codes are in place to manage ethics and unethical behaviour.	Systems are in place to manage, enforce and implement ethics.	Each individual takes ownership of ethics and shares in the rewards.

Sources: IIA (2012a:13-18); Rossouw & Van Vuuren (2013:58)

3.6 Value of internal audit in building ethical culture

According to IIA Standard 2110.A1 (IIA 2012b:11), "the internal audit activity must evaluate the design, implementation, and effectiveness of the organisation's ethics-related objectives, programs, and activities". The Institute for Internal Auditors (IIA 2010:33) advises that the internal audit function should positively influence the tone at the top of the organisation. The internal audit function should promote the ethics and values of an organisation through the assessment of its code of conduct, ethical policy, behavioural standards, tone at the top, and the disciplinary steps taken to address issues of unethical behaviour (NT 2009:51-52; IIA 2012a:1; IIA 2012b: 11; PwC 2010:72). Furthermore, the assessment should include an evaluation of an organisation's ethics strategy, risks, controls, compliance with policies and procedures, and identification of weaknesses in formal and informal systems and processes (IoDSA 2009a:8-9; IIA 2012a:5).

Elmore (2013:51-52) emphasises that the internal audit function can play an important role in promoting the ethical culture of an organisation through the following initiatives: revision of the codes of conduct; inclusion of ethics in the scope of audits; assisting management to schedule ethics training with appropriate content; advising management on establishing a hotline for reporting unethical behaviour and leading the investigations thereof; being an advocate for ethics, and including ethical issues in audit reports for management's attention.

Both the Ethics Institute of South Africa (2014:10) and Von Eck (cited in Dobie & Plant 2014:2) support the principle that both formal and informal systems should be evaluated by the internal audit function. In addition, they emphasise that the internal audit function should include in its evaluation areas such as leadership, staff selection systems, values, policies, codes of conduct, orientation and training, performance management systems, organisational authority structures and decision-making processes. Plant (2008:15) highlights the value-adding role that the internal audit function plays in enhancing an organisation's governance processes by assessing its ethical culture.

4 FINDINGS OF THE EMPIRICAL STUDY

The case study conducted in this research focused on one national department within the South African public sector, and involved discussions with executive staff members and the chairperson of the audit committee. Individual semi-structured interviews were held with two senior members of the executive management (the CAE and the CRO) and the audit committee chairperson (a non-executive director) of that department. The results are discussed below and are presented according to four prominent themes that emerged from the literature review.

4.1 Ethics programme as guideline

Interviewees were asked to share their views about the value of an ethics programme (including a code of ethics and ethics awareness) as a guideline for promoting an ethical culture within their department. Management and the audit committee chair demonstrated a similar level of understanding of the nature and purpose of an ethics programme, and placed a similar level of importance on it. The interviewees agreed that an ethics programme should be comprised of a code of ethics that guides staff on how to behave, a policy with standards/norms that can be used to measure and detect unethical behaviour, and ethics awareness programmes. The chairperson of the audit committee asserted that the ethics programme should include formal (induction programmes) and informal (e-learning) ethics awareness initiatives to educate staff on ethics. The chairperson also highlighted that the effectiveness of ethics programmes should be monitored, in order to determine whether the department is progressing or regressing on ethics training.

Internal assurance structures (internal audit and risk management) within the department use different frameworks to measure ethics. Neither of the structures makes use of the Integrity Ethics framework developed by the DPSA. The risk management unit is familiar with the integrity ethics framework, but uses its own framework to assess ethics; the internal audit unit uses the ethics principles of King III to audit ethics. The chairperson of the audit committee supports the use of King III principles to measure ethics, but also highlighted the importance of ethics risks, which should form part of risk management. The CRO alluded to the fact that risk management in the public sector is regulated by the PFMA Act and the risk framework of the National Treasury. If the internal assurance structures use different frameworks to assess ethics, the goal of an ethical culture is unlikely to be achieved.

4.2 Ethical culture

Interviewees were requested to express their views on the importance of an ethical culture and to indicate the parties that they believed were responsible for developing and maintaining such a culture. Measuring ethical culture is regarded by all three interviewees as an important method by which to ensure that management accounts for their actions, and to provide assurance to the public that the department is transparent and that the tone at the top is correct. According to the chairperson of the audit committee, "what gets measured, gets done", which implies that a department can only improve if it knows its current situation, and where it needs to go in terms of ethics performance. The CRO was of the view that failure to manage ethics can cause reputational damage, while recognising the implicit irony in the fact that the public perception already exists that "government officials are corrupt and lazy".

The audit committee chairperson, CAE and CRO agreed that the responsibility for maintaining an ethical culture lies with the head of a department (the Director General, Accounting officer, and/or other Executive authority), but should be delegated to the ethics officer to ensure that the ethics programme is implemented throughout the department. The ethics function can only be successful if it is supported by the head of the department and the executive management. The audit committee chairperson was of the opinion that responsibility for implementing ethics should be included in the performance agreements of line managers. The ethics culture of the department is also strengthened by the ethics oversight role played by both the audit and the risk management committees in monitoring the implementation of the ethics programme. The success of the ethics programme in the department depends on a collective effort by all staff, the internal assurance providers (internal audit and risk management), and the oversight structures such as the audit committee.

The CAE and CRO were of the view that the public sector should consider implementing a uniform ethics framework, as proposed in this article. The framework should be compulsory and included as part of the performance standards used by the Department of Monitoring and Evaluation (DPME) to measure the ethics performance of all departments in the South African public sector. The public service administrator of DPSA should award an annual incentive to the department that scores highest in its ethics assessment, in order to trigger competition between departments. The CAE suggested that success stories on ethical matters should be communicated to staff to encourage ethical behaviour. The chairperson of the audit committee suggested that departments can also have round-table discussions at which good practices are shared, and where colleagues learn from each other on how and where to improve ethics.

4.3 Ethics management structure and strategy

The interviewees expressed their views on an ethics framework as a management tool and the attributes thereof. They (the CAE, CRO, and chairperson of the audit committee) agreed that a standard ethics framework, such as the one proposed in this article, could be used as a management tool to improve the control environment. The framework could also be used to determine the actual status of ethics in the department, and to develop a plan on how to improve its ethical performance. The CAE and the CRO emphasised that the public sector should have a uniform guiding framework, to ensure consistency in the way in which ethics are measured and to achieve the same common end, namely an ethical and transparent public sector. Many benefits could be realised from a uniform ethics framework. Under a uniform framework new staff could be more easily trained in that staff transferred to another public sector department could quickly become familiar with the new environment, as their ethical practices would be the same. In addition, improvement initiatives to address pervasive gaps could be developed for application across the entire public sector. Furthermore, a framework that is compulsory and properly communicated to the staff of the department will improve the control environment, especially when it is no longer seen as "just an issue of compliance", but rather as a value-adding tool. The chairperson of the audit committee interviewed for this case study supported the idea that the attitude of staff towards compliance will only change if a positive tone is set by top management. Management can demonstrate their support for ethical behaviour by ensuring that sufficient resources are provided for the implementation of the ethics programme, including the development and implementation of an ethics framework.

The CAE and chairperson of the audit committee were of the view that the proposed ethics framework suggested for use by the public sector is comprehensive and covers key ethical attributes. The three interviewees advised that the framework should be enhanced by adding three attributes, namely (1) oversight structures similar to those pertaining to the risk and audit committees, (2) monitoring and evaluation criteria and processes, and (3) learning and improvement. Furthermore, all attributes should be defined by measurable criteria. This means that the criteria should not be open to different interpretations or be seen as subjective, but should be supported by tangible outcomes. The CAE believed that any implementation of the proposed public sector framework should be accompanied by a step-by-step guide that indicates the actions to be taken to enhance an organisation's ethical health.

4.4 Role of internal audit function in ethics assessment

The CAE, CRO and chairperson of the audit committee agreed that internal audit has a vital role to play in the assessment of the ethics of the department. Internal audit should provide assurance to management that controls relating to ethics are adequate and effective to ensure an ethical culture exists, and to make recommendations to management on how to address such gaps in systems or processes that they identify as being likely to lead to unethical behaviour. The chairperson of the audit committee suggested that internal audit should take the lead role in departments where there is as yet no ethics programme in place, and provide management with advice on how to strengthen the ethical culture so as to minimise incidents of fraud and/or corruption. Furthermore, the chairperson was of the opinion that internal audit should include ethics in its audit plan, to ensure it is audited and thus to provide management with assurance on the effectiveness of its ethics programme.

4.5 Summary of the empirical study

In the light of the above findings it appears that an ethics framework could assist internal auditors to assess an organisation's ethics performance and contribute to building an ethical culture. It is also evident that there are areas of the framework that require improvement. This involves the addition of three attributes, namely oversight structures (e.g. risk and audit committees), monitoring and evaluation, and learning and improvement. The proposed framework should also be supported by an implementation guide to avoid misinterpretation and misapplication.

5 PROPOSED ETHICS FRAMEWORK

The proposed ethics framework developed for this study (as discussed in section 2) is set out in Table 3. The framework's attributes were derived from the conclusions generated by the literature study and from the views put forward by the interviewees. Table 3 includes descriptions of the proposed framework's attributes, as well as the roles of the internal audit function with regard to these attributes. The focus of this study is on identifying the relevant attributes of an ethics framework, and not on examining the various levels of ethics maturity. The aim of the framework is that it should be used by the internal audit function within the South African public sector to assess ethical culture and ultimately to enhance organisational governance.

Table 3: Proposed ethics framework for use by the internal audit function

Attributes	Description of attributes	Role of internal audit function
Code of ethics	A code of ethics includes the standards, norms and values that promote ethical behaviour within an organisation. The code of ethics should be developed based on an ethics risk assessment or profiling of the organisation. The code of ethics should prevent unethical behaviour and promote ethical behaviour. The code of ethics and related policies (such as supply chain management, conflicts of interest, gifts and entertainment) should be regularly reviewed and ethical behaviour should be rewarded.	Considerations when assessing the code of ethics: - the process followed to develop the code; - the timeliness of the code; and - the code's alignment with other organisational policies.
Ethical culture	Ethical culture refers to the alignment of formal (policies, procedures, codes) and informal systems (stories, habits, rituals, role-models) within an organisation. Ethical leadership (such as leadership's commitment to ethics and personal alignment with organisation's vision and mission) plays a vital role in ensuring an ethical culture and the right tone-at-the-top. Furthermore, there should be consequences for unethical behaviour, which should be communicated within the organisation. Ethical standards should form part of job descriptions and be regularly assessed as part of the performance management systems.	Considerations when assessing the ethical culture: - leadership commitment; - effectiveness of communication strategy; - culture survey; and - alignment of job descriptions to ethical standards (including performance management systems).
Ethics awareness	Several ethics awareness practices should be implemented within an organisation, such as screening during recruitment, and regular ethics awareness training sessions for all employees covering the code of conduct, disciplinary processes, and reporting of unethical behaviour (such as maintaining a fraud hotline).	Considerations when assessing ethics awareness: - frequency of training sessions; - number of staff trained; - effectiveness of disciplinary processes; and - effectiveness of fraud hotline for reporting unethical behaviour.
Ethics management structure	Various oversight and monitoring functions should be in place to pro-actively manage ethics within the organisation. These could include an ethics officer, a compliance officer, a risk officer and the internal audit function. Furthermore, the audit committee should act as a trusted advisor on all ethics matters.	Considerations when assessing the ethics management structure: - effectiveness of oversight functions in dealing with ethics issues; and - commitment by management to support oversight functions.
Ethics management strategy	The ethics management strategy includes the plan that should be implemented by management to ensure an ethical culture. The strategy should describe a formal ethics programme that includes an ethics risk assessment, a code of ethics, the institutionalisation of ethical standards, as well as the reporting and monitoring of ethics. Issues of non-compliance should be identified, reported and acted on by the responsible structures.	Considerations when assessing the ethics management strategy: - existence of a formal ethics programme; - extent to which the programme has been implemented; - effectiveness of the reporting and monitoring of ethics by relevant structures; and - trend analysis on ethics-related issues (such as increased ethics awareness and reported cases).

6 CONCLUSION

This study reviewed the available literature on ethics in the public sector in a South African context. The concepts of ethical culture and the governance of ethics were also highlighted and discussed. In addition, requirements relating to ethics in King III and other legislative frameworks in the public sector, and maturity models regarding ethics, were studied and discussed. Finally, the role of the internal audit function in using the framework to assess the ethical culture within an organisation was highlighted. The results of a case study, which involved a national department within the South African public sector, were also discussed. Based on both the literature study and the empirical research findings, an ethics framework was developed.

The role of management in the building of an ethical culture for the South African public sector cannot be overemphasised. It should be mentioned that the internal audit function also has a role to play in assessing the ethical culture in public sector organisations in South Africa. This can be achieved by using the proposed framework to assess the ethical culture of the organisation. The use of the said framework is supported by the interviewees in the case study, and their collective view is that its implementation would contribute to strengthening the control environment and ethical culture of the public sector.

The limitation of this study, being that its empirical research component was limited to the viewpoints of two executives and the audit committee chairperson in one national public sector department in South

Africa, provides an opportunity for further research. Furthermore, a comprehensive study of the different levels of maturity for the attributes identified in this study could also provide an opportunity for further research. The views of various stakeholders, such as the auditor-general, trade unions, and public administrators, on developing a guideline or policy to supplement the use of the ethics framework in all spheres of government could be beneficial to the further development of the framework. The framework should become part and parcel of public sector policy to ensure enforcement, and should be used by the internal audit function as a standard assessment tool for ethics, ultimately contributing to an ethical organisational culture and improved governance.

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Evolving Research

Combined assurance: A systematic process

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ABSTRACT

There is a clear shift in corporate governance towards understanding and managing the risks that could prevent an organisation from achieving its objectives. This has resulted in enterprise risk management and combined assurance becoming fundamental and integral components of corporate governance. Although enterprise risk management is a well-researched field, limited research is available on the introduction and/or maintenance of combined assurance processes, and how these relate to enterprise risk management. The objectives of the study reported on in this article are twofold. Firstly, it presents the interrelationships between the features of enterprise risk management and the combined assurance processes. Secondly, by conducting a survey of the views of chief audit executives within the private sector it determines how these features were considered and addressed by organisations during the introduction and subsequent maintenance of their organisations' combined assurance processes. The most significant finding is that there appears to be a dependency on the enterprise risk management process as a prerequisite for the implementation of a combined assurance process. Furthermore, significant differences were found to exist between perceptions from respondents from companies that had already implemented combined assurance / enterprise risk management and those respondents from companies that are currently in the process of implementing combined assurance / enterprise risk management.

Key words

Corporate governance; combined assurance; enterprise risk management; internal audit; combined assurance features; combined assurance benefits; combined assurance role players

1 INTRODUCTION

Corporate governance became a matter of public debate in the early twentieth century (Wells 2010: 1291). In more recent times though, corporate governance has again become a buzz phrase and is receiving far more substantial attention from boards, regulators and various other business stakeholders. Traditional approaches to corporate governance have also been forced to evolve in response to corporate governance failures that have themselves highlighted previously noted areas of concern (Kirkpatrick 2009: 63). Over time there has been a clear shift towards understanding and managing the risks that could prevent an organisation from achieving its objectives (IIA 2012b:1; Brink 2009:9; Marks 2009:23). Enterprise Risk Management (ERM), a process of identifying events that may impact the organisation, and the management of risks so that they are within the enterprise's risk appetite across all business structures, has become a fundamental and integral component of corporate governance (IIA 2012b:1; Brink 2009:9; COSO 2009:4; Marks 2009:23; COSO 2004a:2). Furthermore, boards now have increased responsibilities regarding the oversight of all aspects of risk, and should be obtaining appropriate assurance that key risks are competently managed and mitigated. This has given rise to the concept of combined assurance, the basis of today's corporate governance, which involves various parties that collectively provide assurance that all the significant risks facing the organisation are appropriately mitigated (IoD 2009:52-53) and then integrated with ERM's efforts (Pearl-Kumah, Sare & Bernard 2014:1; IIA 2012b:1; Brink 2009:9; Marks 2009:23).

Causes cited for the 2008 global financial crisis and associated corporate failures relate to poor corporate governance and risk management practices (Kumar & Singh 2013:21; Sarens, Decaux & Lenz 2012:7; Marks 2009:23; Mardjono 2005:272). Countering these has manifest as the development of processes, structures and cultural safeguards that ensure the long-term sustainability of the organisation in the best interest of stakeholders (Fombrun 2006:267). Risk management is a central task and a fundamental component of organisational control and sound corporate governance (IIA 2012b:1; Pirson & Turnbull 2011:459; Brink 2009:9; Marks 2009:23). Furthermore, systems that have been put in place for the monitoring and management of foreseeable risk factors are key features of The Organisation for Economic Co-operation and Development's (OECD) Principles of Corporate Governance (Kirkpatrick 2009:62).

The third King Report on Corporate Governance in South Africa (King III) formally introduced the concept of combined assurance in 2009 (IoD 2009:52). The broad aspects of the concept are not new and are similar to assurance mapping (Hardy 2014; Hodge 2012) and integrated assurance (Beale 2013; Hodge 2012). The formal combined assurance model implemented by an organisation aims to optimise the assurances received from management and from internal and external assurance providers pertaining to the risks impacting on the organisation, and together their combined assurance should be sufficient to satisfy the board / audit committee that the significant risks facing the organisation are being appropriately mitigated (IoD 2009:53). The objectives of ERM and combined assurance are similar in that risks should be appropriately managed or mitigated to ensure that the objectives of the organisation are achieved (COSO 2009:4; IoD 2009:53; COSO 2004a:2). In addition, the internal audit function (IAF) is responsible for providing assurance to the board / audit committee that governance, risk management, control processes (IIA 2013; IoD 2009:81) and combined assurance are effective (IoD 2009:81), and collectively underpinning sound corporate governance.

The objectives of the study reported on in this article are twofold. The first objective is to present the interrelationships between the features of ERM and combined assurance processes. The second objective is to determine how these processes' features have been considered and addressed by organisations during the introduction and subsequent maintenance of their organisations' combined assurance processes. This has been effected by conducting a survey of the views of chief audit executives (CAEs)[1] within the private sector.

Although formal implementation of combined assurance became mandatory from 2010 (IoD 2009), limited research has been performed on the actual processes followed by organisations, either when introducing or subsequently maintaining such processes (Sarens *et al* 2012:75, 117). Anecdotal evidence suggests that some organisations are still grappling with its implementation, while for others implementation has long since been completed and the systems are now being reviewed. Thus, determining the perceptions of CAEs on the challenges encountered while implementing a combined assurance process could provide insights which may be useful for organisations that have not yet completed the implementation of a combined assurance process, or that intend to improve on their existing processes. The Institute of Internal Auditors (IIA), the internal audit industry in general, and other role players (executives, board / audit committee members and risk functions) could also benefit from these findings in that they identify areas where further guidance is needed. And finally, it has been reported that the King Commission will be revising the King III report (Business Day 2014; IoD 2014) and this study could offer first-hand insights into the combined assurance practices currently followed by organisations.

The remainder of the article is structured as follows: the next section gives a literature overview to contextualise the findings of the study. This is followed by a discussion of the features in the ERM process, which are compared with the combined assurance process to identify interrelationships. Thereafter the research method is explained and this is followed by a discussion of the findings of the survey. The article concludes with a presentation of recommendations and the identification of areas for possible future research.

2 LITERATURE REVIEW

2.1 Nature and evolvement of corporate governance, risk management and combined assurance

Risk management is a corporate governance task which is central to efforts to sustain value creation (Pirson & Turnbull 2011:459). The global financial crisis of 2007/2008, and other recent corporate failures (Enron, World Com, BP, Arthur Andersen, Northern Rock and Cadbury Schweppes - all notorious for the value that was destroyed), have been attributed to various causes ranging from folly, fraud and greed to outright incompetence (Pirson & Turnbull 2011:459). Many of these failures had their origins in poor corporate governance (Kumar & Singh 2013:21; Sarens *et al* 2012:7; Marks 2009:23; Mardjono 2005:272). Inferior and fragile risk management practices, resulting in boards not being aware of underlying risks to their organisation, have also been cited as further major reasons for the financial crisis and recent corporate failures (Kumar & Singh 2013:21; Hopkin 2012:50; Sarens *et al* 2012:7; Marks 2009:23).

Since risk management has come to be regarded as a fundamental component of organisational control and sound corporate governance, the implementation of the concept of ERM has also gained momentum (IIA 2012b:1; Brink 2009:9; Marks 2009:23). ERM tools are required to predict and manage the vast array of risks that could impact on the long-term sustainability of the organisation. Addressing these ensures objectives are achieved, stakeholder needs are considered and governance is improved (Arena, Arnaboldi & Azzone 2011:779; Schanfield & Helming 2008:41; Drew, Kelley & Kendrick 2006:127). ERM is defined by the Committee of Sponsoring Organisations (COSO) as follows (COSO 2009:4; COSO 2004a:2):

> *"Enterprise risk management is a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives".*

In 2009 the King III report formally introduced to South African business the concept and recommended the associated practice of combined assurance (IoD 2009:52). Combined assurance is not a new concept, and agrees in principle with the elements of assurance mapping and integrated assurance. In these latter two processes the key risks of an organisation are mapped (linked) to assurance practices in an effort to ensure that all risks are adequately covered, and to reduce duplication of effort (Hardy 2014; Beale 2013; Hodge 2012). This is in line with the definition of combined assurance as the process of co-ordinating the efforts of management with those of internal and external assurance providers in order to jointly satisfy the board / audit committee that the significant risks facing the organisation are appropriately addressed / mitigated in order for the organisation to achieve its objectives (Grant Thornton 2012:2; Roos 2011/2012: 32; Finweek 2010:46; KPMG 2010:1; Brink 2009:10; IoD 2009:53).

2.2 Role of the IAF

In terms of the definition of internal auditing, the IAF is tasked to "evaluate and improve the effectiveness of risk management, control, and governance processes" (IIA 2013). This is achieved by the IAF being an "independent, objective assurance" activity, and these attributes are widely supported by the literature (Chambers 2014:199; Plant, Coetzee, Fourie & Steyn 2013:67; Soh & Martinov-Bennie 2011:607; Stewart & Subramaniam 2010:330-331). Assurance activities form part of the corporate governance and risk management processes that assist the board in monitoring the business of the organisation, as is required by the stakeholders. These activities contribute to the managing of principal risks in order to achieve objectives, by informing management and the audit committee / board what processes are effective and what are not (KPMG 2012:7; Sarens *et al* 2012:14-15; Deloitte 2011:1; Parkinson 2004:66). Internal audit should provide objective assurance to the board regarding the effectiveness of risk management or ERM (including the risk management processes, evaluation of risks, appropriateness of risk responses, how key risks are managed and risk reporting), to assist an organisation to accomplish its objectives (IIA 2012a:11; De Zwaan, Stewart & Subramaniam 2011:586-588; IIA 2009:3-4, COSO 2004b:104).

The IAF should also be a significant role player in combined assurance (IoD 2009:81). The CAE is already expected to share information with and coordinate activities between internal and external assurance providers, in accordance with the International Professional Practices Framework (Standard 2050 – Coordination) (IIA 2012b:10). The implementation of the combined assurance process could be championed by the IAF; however, this is dependent on capacity, structure and maturity of the function (Grant Thornton 2012:5; Deloitte 2011:2). The board / audit committee should receive assurance from the IAF that the combined assurance process that has been implemented is effective in its efforts to optimise cost efficiencies, and to prevent assurance fatigue and duplication of effort (IoD 2009:81). Furthermore, internal audit has a vested interest in the successful implementation of a combined assurance model due to the vast number of risks an organisation is exposed to, and because they perform the annual internal audit assessment on the effectiveness of the system of internal control and risk management, in line with the requirements of King III (Grant Thornton 2012:4; IIA 2012b:5; Deloitte 2011:3).

2.3 Interrelationships between features of an ERM process and the combined assurance process

In an attempt to reach the first objective of this study, the interrelationships between the features of ERM and combined assurance processes are identified in this section. Both ERM and combined assurance are corporate governance mechanisms (IIA 2012b:1; Brink 2009:9; IoD 2009:52; Marks 2009:23), with a shared theoretical foundation in agency theory (Judge 2012:123; Darus & Mohamad 2011:126; Nyberg, Fulmer, Gerhardt & Carpenter 2010:1030; Bonazzi & Islam 2007:7; Adams 1994:8), intended to redirect narrowly defined self-interests into positive organisational outcomes (Westphal & Zajac 2013: 608). And from the perspective of stakeholder theory (Hasnas 2013:52; Garvare & Johansson 2010:737; Mardjono 2005:272; Attas 2004:315-316), both mechanisms are intended to maintain a balance between the various stakeholders' sometimes conflicting need for and definitions of sustainability (Mainardes, Alves & Raposo 2011:227-228; Garvare & Johansson 2010:737; Alpasan, Green & Mitroff 2009:43).

ERM and combined assurance are processes which focus on risks, and both aim to provide reasonable assurance regarding the achievement of entity objectives (IoD 2009:53; COSO 2004a:2). The risk management philosophy includes understanding the risk appetite of the significant stakeholders of the organisation (Walker & Shenkir 2008; Ballou & Heitger 2005:5-6). For this purpose an ERM process is used, operating on a strategic level that encompasses the whole organisation, in order to ensure that reasonable assurance can be provided that an organisation is achieving its goals through the identification, assessment and management of risks (Paape & Specklé 2012:1; Arena *et al* 2011:659). In addition to this, a combined assurance process aims to optimise assurance with coverage of the organisation's risks being obtained from management, and internal and external assurance providers (Deloitte 2011:1; KPMG 2010:1; PWC 2010:4; IoD 2009:53).

An organisation could benefit by introducing an ERM process, supported by a combined assurance process, as these will improve compliance and corporate governance. The benefits of ERM, according to the literature (Fadun 2013:74; IIA 2009:2-3; Frazer, Schoening-Thiessen & Simkins 2008:77; Schanfield & Helming 2008:42-43) include: more effective decision-making, improved likelihood of achieving objectives, better understanding and management of risk, reduced risk exposure (thus fewer surprises), more effective business processes, operations that are more efficient and profitable, and the establishment of a risk-aware business culture. When ERM is employed in conjunction with a combined assurance process that coordinates assurance efforts (by focusing on key risk exposures, reducing assurance fatigue, and identifying areas for improvement and assurance gaps for which corrective or remedial actions could be tracked and prioritised), a comprehensive view of the organisation's risk exposures (and how these risks are being managed) is generated (EY 2013:2; Grant Thornton 2012:4; Deloitte 2011:4; Roos 2011/2012:32; PWC 2010:4; Brink 2009:10; IoD 2009:81). This enables the organisation to reduce assurance costs by limiting duplication of effort, while directors and stakeholders are nevertheless still provided with essential comfort that key risks are being adequately addressed (EY 2013:2; Grant Thornton 2012:4; Deloitte 2011:4; Roos 2011/2012:32; PWC 2010:4; Brink 2009:10; IoD 2009:81).

The organisation must identify its objectives and determine related strategies before possible events can be identified that could impact the achievement of these objectives (Walker & Shenkir 2008; Ballou & Heitger 2005:7; Thomson Reuters, n.d.:2). The objectives should be aligned to the organisation's mission, and should recognise its risk appetite (Ballou & Heitger 2005:7; Thomson Reuters, n.d.:2). Through an ERM process an organisation is able to identify, assess and manage risks that could impact the organisation's objectives (COSO 2009:4; COSO 2004a:2). Once the organisation's objectives have been established, possible internal and external events (both risks and opportunities) that could impact the achievement of objectives should be identified (Arena *et al* 2011:779; Thomson Reuters n.d.:2). The identified events should be prioritised in terms of significance, frequency of likely occurrence and the impact of time on the event (Arena *et al* 2011:780; Schanfield & Helming 2008:43; Thomson Reuters n.d.:5). In addition, a clear understanding should be obtained of the organisation's risk appetite, the maturity of its risk assessment process, its business objectives, value drivers and key risks, and whether its financial and non-financial risks (operational, regulatory and strategic) have been considered (EY 2013:8; Deloitte 2011:2; KPMG 2010:[1]). The successful implementation of a combined assurance process requires a thorough understanding of the organisation's business objectives, risk appetite, key processes, and its significant risks and their controls; as previously noted, these are features of an ERM process. Therefore, there should be an ERM process in place before a combined assurance process is implemented, thus demonstrating combined assurance's dependency on the ERM process. This dependency on the ERM process represents a challenge for the implementation of a combined assurance model, should ERM not yet have been implemented or still be in an immature state.

Both processes require the board, audit committee, management and internal audit to be role players (Grant Thornton 2012:3,5; Sarens *et al* 2012:26-29; Deloitte 2011:1; Muller 2011; Brink 2009:9; IoD 2009:52-53,65; Fraser & Henry 2007:405,407; COSO 2004b:95-101,103; Sobel & Reding 2004:30-32; Nkonki n.d.:2). Management is accountable to the board for all matters pertaining to risk, and specifically for risk assessments, risk responses and monitoring of risk (Sarens *et al* 2012:29; IoD 2009:65). The organisation's internal assurance providers (internal audit, risk management, compliance, forensics, legal, and health and safety departments) and external assurance providers (external auditors, independent actuaries, external consultants, sustainability and environmental experts, and Organisation for Standardisation (ISO) assessors) provide assurance over the identified risks (Sarens *et al* 2012:28; Deloitte 2011:1; IoD 2009:53). Internal audit (refer to section 2.2), as key assurance provider on risk management processes (the evaluation of risks, management of key risks and reporting thereof), plays a pivotal role in the ERM and the combined assurance processes.

Similar techniques are used by the IAF in both processes, due to their interdependency, and both processes could hold cost benefits (Arena *et al* 2011:780; Schanfield & Helming 2008:43-44; Walker & Shenkir 2008; Ballou & Heitger 2005:8). Combined assurance training should be conducted to ensure that key role players are on board; this is the equivalent of establishing a risk culture that institutionalises the risk awareness/mitigation process in terms of ERM (EY 2013:9; Schanfield & Helming 2008:44; Ballou & Heitger 2005:5-6).

A systematic process should be implemented whereby the opportunities for combined assurance are identified, responsibilities are assigned, assurance providers identified and actual or potential assurance is mapped to strategic, key operational and business unit level processes (EY 2013:8; Deloitte 2011:1; KPMG 2010:1; PWC 2010:4,7; Nkonki n.d.:3). This establishes the assurance universe - what is being done and for what reasons (EY 2013:8; PWC 2010:6). The actual assurances received should be mapped to the organisation's risks (EY 2013:8; PWC 2010:6). Assurance mapping in combined assurance is similar to performing a cost benefit analysis for treatment plans in an ERM process, ensuring that the appropriate assurance provider is providing assurance over the most significant risks, which eliminates or reduces duplication, assurance fatigue and assurance gaps (EY 2013:9; PWC 2010:10). A remediation plan (as part of the systematic process), should be developed and implemented to address duplication and assurance gaps (EY 2013:9; KPMG 2010:1). This is similar to ERM's policies and procedures that ensure risk treatment plans are implemented (Schanfield & Helming 2008:44; Ballou & Heitger 2005:8).

In line with the implementation of an ERM process, a combined assurance process should also inform the appropriate parties on how risks are managed, as well as explaining the assurances received regarding mitigation of significant risks. Both the combined assurance and the ERM processes should be continuously monitored and enhanced to ensure they remain current, continue to add value and evolve with the organisation and its environment (EY 2013:9; Arena *et al* 2011:780; Deloitte 2011:3; KPMG 2010:1; Schanfield & Helming 2008:44; Ballou & Heitger 2005:8).

3 RESEARCH METHODOLOGY

This article reports on the results of a deductive study (Bryman 2012:24). The study pursued a literature review to determine the currently understood interrelationships between the features of ERM and combined assurance processes, and this was supplemented by quantitative research that collected empirical evidence on how these features have been (or will be) considered by organisations within the private sector during the introduction or maintenance of combined assurance processes.

An e-mail and electronic survey (using a structured questionnaire) was deemed to be the most appropriate method for data collection as the study is substantially descriptive in nature, dealing mostly with questions on current practice (Babbie 2014:261; Zikmund, Babin, Carr & Griffin 2013:53; Thomas, Nelson & Silverman 2011:273). The survey questionnaire was divided into two sections. The first section concentrated on the respondent's profile (experience and qualifications) and the background of his / her organisation (its primary industry and shareholding status). The second section focused on the combined assurance process. The first objective here was to determine the maturity of the combined assurance and ERM processes within the respondent's organisation in order to contextualise responses. The next section contained various questions intended to determine the level of importance of specific factors and features present within the respondents' combined assurance process; the questions were developed from the elements discovered during the literature review. The questionnaire was pilot-tested by a senior internal audit manager and by an internal audit manager, each employed by large publicly listed private sector organisations. Ethical clearance for the study had previously been obtained from the University of Pretoria.

The survey questionnaire was distributed in two phases. In the first phase, a combination of purposive and judgemental sampling was utilised (Bryman 2012:418; Doyle 2011:340), whereby 28 CAEs within the private sector were identified and approached by means of a personalised e-mail invitation to participate in the study. The e-mail invitation was sent out on 29 August 2014. The e-mail invitation was followed by a second e-mail which included a formal, personalised letter of introduction and the survey questionnaire. The CAEs who had previously indicated that they were not willing to participate in the study were excluded from this mailing. The second e-mail was thus distributed to 25 CAEs on 7 September 2014. Weekly reminder e-mails were distributed up to 29 September 2014. This approach was followed in an attempt to increase the questionnaire's response rate. The second phase involved accessing the IIA's database of members to whom a bulk e-mail invitation was sent specifically inviting CAEs within the private sector to participate in the study. The bulk e-mail was distributed on 22 September 2014. A further 10 CAEs within the private sector were identified by means of purposive or judgemental sampling. An e-mail was sent to the identified CAEs on 22 September 2014, which again included a formal personalised letter of introduction and the survey questionnaire. Reminder e-mails were sent to this last group of CAEs on the 29 September 2014.

The survey questionnaire was submitted to CAEs within the private sector who were understood to be the highest ranking person responsible for the IAF in their organisations, and thus the most knowledgeable within their organisations on the subject of combined assurance, due to the important role the IAF should play within combined assurance (Grant Thornton 2012:5; IIA 2012b:10; Deloitte 2011:2). The distribution of the survey questionnaire was limited to the private sector because recent research has shown that the public sector's understanding of combined assurance appears to be "limited" (National Treasury 2014:2). Additional motivation for addressing the private sector CAEs is that the Johannesburg Stock Exchange (JSE) regulations require companies to "apply" King III principles or "explain" why they were not implemented (Deloitte 2011:1), adding further incentive for the private sector to implement a combined assurance process.

In total 38 CAEs were identified by means of purposive and/or judgemental sampling and twenty-nine of the 38 CAEs so identified finally participated in and completed the survey. This represents a 76% response rate. No responses were received from the bulk e-mail distributed by the IIA. The IIA confirmed that there are approximately 670 CAEs within the private sector recorded in their database (Brazao 2014). The twenty-nine CAEs that finally participated and completed the survey thus represent a response rate of four percent of all CAEs in the private sector.

This study was therefore based entirely on the responses received through purposive and judgemental sampling, which makes the sample "not representative". The results of the study should therefore be considered in the context of this limitation; but despite this, as combined assurance processes are a relatively unexplored area, the results will enhance the knowledge of this field.

4 RESULTS AND DISCUSSION

4.1 Respondents' profiles and organisational backgrounds

The CAEs were requested to indicate the number of years of experience they had as a CAE, and their professional qualifications. The majority of the CAEs (55%) had more than three years but less than 10 years of experience as a CAE, while for 24% of the respondents their experience was less than three years, and for 20% it amounted to more than 10 years of experience as a CAE. More than three quarters (76%) of the respondents were *Certified Internal Auditors*, 41% were *Chartered Accountants*, 17% had *Certifications in Control Self-Assessment*, 14% were *Certified Financial Services Auditors* and 10% had *Certifications in Risk Management Assurance*.

The majority of the CAEs operated within the financial services industry. The bulk of the respondents' organisations (79%) were listed on the JSE, while five respondents (17%) reported that their organisations were not listed on the JSE, nor on any other exchange.

4.2 The maturity of the combined assurance process within the respondents' organisations

Combined assurance had already been implemented by 15 (52%) of the respondents, while 10 (34%) reported being in the process of implementing combined assurance. The major organisational functions identified by these respondents as being responsible for the implementation and maintenance of the combined assurance process (combined assurance champions) include *internal audit* (88%), *risk management* (68%), *executive management* (32%), *compliance* (28%), *legal* (24%) and *forensics* (12%). Combined assurance had not yet been implemented by four (14%) of the respondents (three of the four companies are listed on the JSE). Furthermore, six of the 10 respondents that are in the process of implementing combined assurance are listed on the JSE. The relative seriousness of this finding rests on whether these companies have formally "explained" the extent to which they adhere to the King III principles, because the JSE regulations require companies to "apply", or "explain" why the King III principles have or have not been implemented (Deloitte 2011:1).

The respondents that have implemented or are in the process of implementing combined assurance were required to rate the maturity of their combined assurance process on a 5-point Likert scale (1 - not mature and 5 - extremely mature). The average maturity rating of the combined assurance process claimed by the respondents that had already implemented combined assurance was above average (3.47), and very low (1.6) for the respondents that were in the process of implementing combined assurance.

4.3 The maturity of ERM within the respondents' organisations

A higher number of respondents (23, representing 79%) reported that their organisations have implemented ERM, while six (21%) were in the process of implementing ERM. Following the same 5-point Likert scale as above, the average maturity rating of ERM for the respondents that had already implemented ERM was above average (3.48), and again very low (2.00) for the respondents in the process of implementing ERM. An interesting observation is that for all the organisations where a combined assurance process had been implemented, ERM had also been implemented. The average combined assurance maturity rating (3.47) where the combined assurance process had been implemented was closely related to the average ERM maturity rating (3.67) within the same organisations. Not unexpectedly, it was also evident that where combined assurance was in the process of being implemented or was soon to be implemented the average ERM maturity rating was below average (2.64). It thus appears to be that a mature ERM is required before a combined assurance process can be implemented, a finding that is also supported in the literature where interrelationships between the ERM and combined assurance processes have been investigated.

4.4 Factors considered to be part of the combined assurance process

The respondents were required to rate on a 5-point Likert scale (1 - not all and 5 - extreme consideration) the extent to which specific factors (the organisation's key activities/processes, business objectives, value drivers, risk appetite, financial risks, operational risks, regulatory risks and strategic risks (EY 2013:8; Deloitte 2011:2; KPMG 2010:[1])) were considered to be part of the combined assurance process in their organisations. If a combined assurance process had not yet been implemented respondents were requested to consider the likely level of importance that would be attached to these factors during the implementation. The average consideration ratings for these factors were then determined. The organisation's *financial risks* (3.83), *key activities and processes* (3.72), *regulatory risks* (3.72), *operational risks* (3.69) and *strategic risks* (3.45) received above average scores and therefore represent the factors most frequently considered to be part of the combined assurance process. The *organisation's value drivers* (2.93), *risk appetite* (3.21) and *business objectives* (3.31) received average scores and were considered to be less important parts of the combined assurance process.

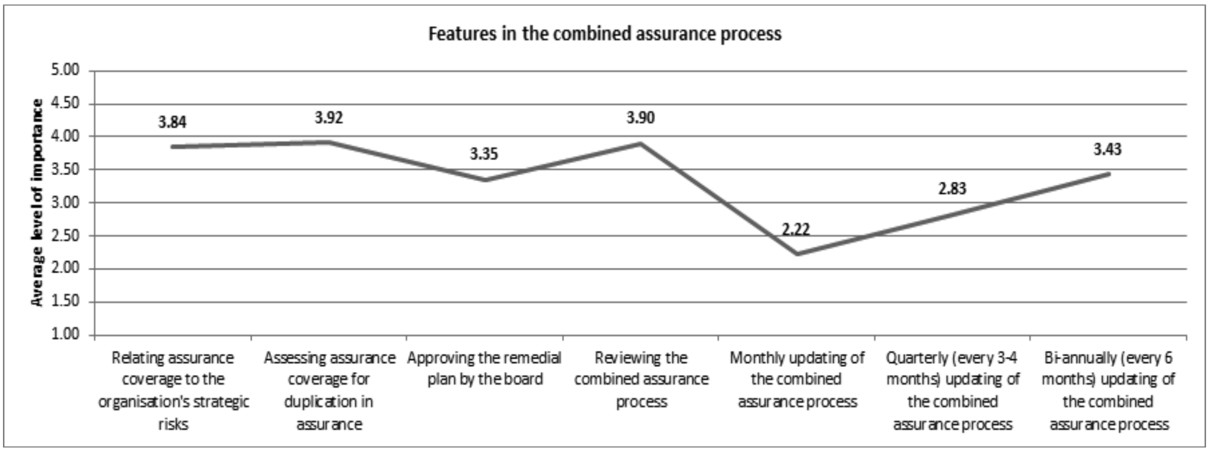
Further tests were performed on the data to determine the statistical significance of the differences between the responses from respondents in organisations that have already implemented combined assurance and those from organisations that were in the process of implementing combined assurance. The Mann-Whitney non-parametric test was used due to the small sample size and ordinal scaled data. A statistically significant difference was found to exist between respondents from organisations that have implemented combined assurance and respondents from organisations that are currently implementing combined assurance, for the following combined assurance factors: *business objectives* (U = 36.00, $p < 0.05$) and *value drivers* (U = 40.50, $p < 0.05$). These differences were determined at the five percent level of significance. Furthermore, the mean ranks indicate that respondents from organizations that have implemented combined assurance are more likely to consider their organizations' *business objectives* and *value drivers* (mean ranks of 15.6 and 15.3 respectively) as part of their combined assurance processes, than are the respondents from organizations that are currently implementing combined assurance (mean ranks of 9.10 and 9.55 respectively).

Statistically significant differences (both at the five percent and at the 10% levels of significance) exist between respondents in organisations that have implemented ERM and respondents in organisations that are currently implementing ERM, regarding the following combined assurance factors: *business objectives* (U = 35.00, $p < 0.10$), *value drivers* (U = 31.50, $p < 0.05$), *risk appetite* (U = 32.00, $p < 0.05$) and *strategic risks* (U = 34.00, $p < 0.05$). Furthermore, the mean ranks indicate that the respondents in organizations that have implemented ERM are more likely to consider their organizations' *business objectives, value drivers, risk appetite and strategic risks*, (mean ranks of 16.48, 16.63, 16.61 and 16.52 respectively) as part of their combined assurance processes than are respondents in organizations that are currently implementing ERM (mean ranks of 9.33, 8.75, 8.83 and 9.17 respectively).

4.5 Levels of importance attached to the steps / features of the combined assurance process

The respondents that have implemented or are in the process of implementing combined assurance had to rate the level of importance that they attached to each of 27 features of the combined assurance process (as set out in Annexure A) on a 5-point Likert scale (1 - not important and 5 - extremely important). These features related to five themes identified from the literature: responsibility for the process; assurance providers; assurance and risk mapping; checks in the process, and monitoring and reporting. The average level of importance ratings was determined and for 20 of the features very high scores (at least equal to 4.00) were obtained. Seven features, as depicted in Figure 1, were rated below 4.

Figure 1: Features in the combined assurance process with lowest average scores



Further tests were performed on the data to determine the statistically significant differences between responses from respondents in organisations that have implemented combined assurance and those that were in the process of implementing combined assurance. The Mann-Whitney non-parametric test was conducted. A statistically significant difference was found to exist between respondents from organisations that have implemented combined assurance and respondents from organisations that are currently implementing combined assurance for the following combined assurance features: *the identification of assurance providers* (U = 32.00, $p < 0.05$); *assessing assurance coverage for excessive assurance* (U = 37.00, $p < 0.05$), and *duplication of effort* (U = 39.00, $p < 0.05$). These differences existed at the five percent level. Furthermore, the mean ranks indicate that the responses from respondents in organizations that are currently implementing combined assurance tend to rate the level of importance of the *identification of assurance providers, assessing assurance coverage for excessive assurance*, as well as *duplication in effort* higher (mean ranks of 17.30, 16.80 and 16.60) than the responses from respondents in organizations that have already implemented combined assurance (mean ranks of 10.13, 10.47 and 10.60). A probable explanation for this could be that for organizations that have already implemented combined assurance, these were preliminary actions long since completed, and thus are not rated as being as important as they are to organizations that are still in the process of implementing combined assurance.

4.6 Assurance regarding the effectiveness of combined assurance

The respondents that have implemented or are in the process of implementing combined assurance had to rate on a 5-point Likert scale (1 - not at all, 5 - significantly agree) the extent to which the board relies on the assurance provided by specific parties regarding the effectiveness of the combined assurance process. The average ratings were calculated and very high scores were received for the *audit committee* (4.42) and the *IAF* (4.33), identifying them as the primary parties the board relies on for assurance of the effectiveness of the combined assurance process. Above average scores were also received for the *risk management function* (3.65) and *external audit* (3.58).

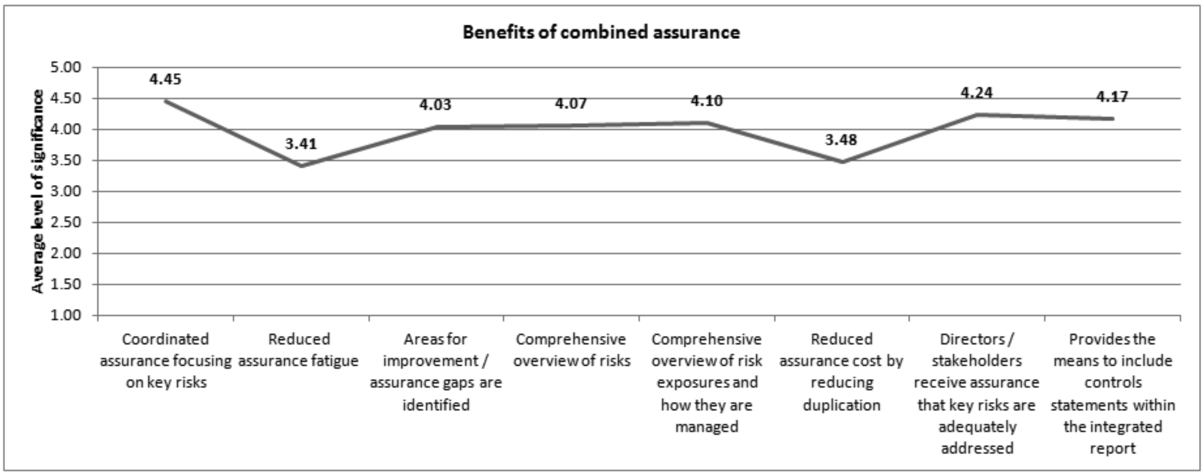
As was done for the findings already reported, the Mann-Whitney non-parametric test was again performed to determine statistically significant differences between responses from respondents in organisations that have already implemented combined assurance and those that were still in the process of implementation. A statistically significant difference was found to exist at the five percent and 10% levels of significance, between responses from respondents in organisations that have implemented combined assurance and responses from respondents in organisations that are currently implementing combined assurance regarding the parties that the board relies on to provide assurance on the effectiveness of the combined assurance process. These parties were: the *audit committee* (U = 43.00, $p < 0.10$) and the *risk management function* (U = 32.00, $p < 0.05$). Furthermore, the mean ranks indicate that the respondents from organizations that have already implemented combined assurance reported that their boards place more reliance on the assurance provided by the *audit committee* and the *risk management function* regarding the effectiveness of the combined assurance process (mean ranks of 15.13 and 15.87) than was reported by respondents from organizations that are currently implementing combined assurance (mean ranks of 9.80 and 8.70).

A probable explanation for this could be that for those respondents in the process of implementing combined assurance, the average maturity ratings of combined assurance and ERM are very low (1.6) and below average (2.64) respectively, and therefore they are not yet in a position to provide assurance over the combined assurance process.

4.7 Benefits of combined assurance

Lastly, the respondents had to indicate the extent to which they agreed with eight advantages of combined assurance identified during the literature review. Following the same 5-point Likert scale as above, the average ratings were calculated and the majority of the benefits received very high scores (equal to or above 4.00). The respondents significantly agreed that *combined assurance results in a more coordinated effort to ensure assurance efforts address key risk exposures* (4.45); that *combined assurance provides directors / stakeholders with the assurance that key risks are being adequately addressed* (4.24), and *combined assurance also enables the inclusion of control statements within the integrated report* (4.17), in line with the requirements of the King III report. *Reducing assurance fatigue, resulting in fewer operational disruptions* (3.41) and *reducing assurance costs by limiting duplication of effort* (3.48) also received above average scores. Figure 2 provides a breakdown of the average scores awarded to the previously identified combined assurance benefits.

Figure 2: Benefits of combined assurance



In line with the findings already reported, a Mann-Whitney non-parametric test was performed to determine the statistical significance of differences between responses from respondents in organisations that have implemented combined assurance and those that were in the process of implementing combined assurance, as well as between those that have implemented ERM and those that were in the process of implementing ERM. A statistically significant difference was found to exist at the five percent level of significance, between responses from respondents in organisations that have implemented combined assurance and responses from respondents in organisations that are currently implementing combined assurance for the following combined assurance benefits: *a comprehensive overview of risks* (U = 32.00, $p < 0.05$), and *directors / stakeholders receiving assurance that key risks are adequately addressed* (U = 39.50, $p < 0.05$). Furthermore, the mean ranks indicate that the responses from respondents in organizations that have already implemented combined assurance were higher with regard to the combined assurance benefits pertaining to *providing a comprehensive overview of risks*, and *directors / stakeholders receiving assurance that key risks are adequately addressed* (mean ranks of 15.87 and 15.37) than responses from respondents in organizations that are currently implementing combined assurance (mean ranks of 8.70 and 9.45). A probable explanation for this could be that, due to the average maturity ratings of combined assurance and ERM for respondents in the process of implementing combined assurance being very low (1.6) and below average (2.64) respectively, the abovementioned benefits have not yet been experienced or have only been experienced to a lesser extent.

A statistically significant difference exists at the five percent level of significance, between responses from respondents in organisations that have already implemented ERM and responses from respondents in organisations that are currently implementing ERM pertaining to the combined assurance benefit *directors / stakeholders receiving assurance that key risks are adequately addressed* (U = 28.00, $p < 0.05$). Furthermore, the mean ranks indicate that the responses from respondents in organizations that have implemented ERM rank the combined assurance benefit pertaining to *directors / stakeholders receiving assurance that key risks are adequately addressed* higher (mean rank of 16.78) than do respondents in organizations that are currently implementing ERM (mean rank of 8.17).

The analysis of the responses revealed that it appears to be a prerequisite that a mature ERM process already exists before the implementation of a combined assurance process can successfully be undertaken. Furthermore, utilising the Mann-Whitney non-parametric test, significant differences at the five percent and 10% level of significance were identified between respondents from companies that had already implemented combined assurance / ERM and those respondents from companies that are currently in the process of implementing combined assurance / ERM, relating to the combined assurance process.

5 CONCLUSION

Oversight responsibilities of boards have increased significantly, especially in the areas of risk oversight and obtaining assurance that significant risks are managed and mitigated to acceptable levels (within the organisation's risk tolerance levels). The appropriate management and mitigation of the risks facing an organisation are objectives of both ERM and combined assurance. The IAF plays a significant role within the ERM and combined assurance processes by providing assurance to the board / audit committee regarding the effectiveness of both processes. The results of the study support the view that the IAF is a major role player in the combined assurance process.

Interrelationships and similarities exist between the features of the ERM and the combined assurance processes. The most significant finding was that there appears to be a dependency on the ERM process as a prerequisite for the implementation of a combined assurance process. A key feature of combined assurance is the mapping of assurance to the organisation's risks. The focus of ERM is to identify the risks and opportunities which could impact the organisation's objectives. ERM should therefore be in place before a combined assurance process is implemented. Analysis of the responses from respondents in organisations that have implemented combined assurance and those currently implementing combined assurance revealed that organisations that have already implemented a combined assurance process had more mature ERM processes in place than did organisations in the process of implementing combined assurance, which supports the above-mentioned finding. Furthermore, the data analytics also revealed that nearly half of the respondents are currently in the process of implementing combined assurance, or will be implementing combined assurance soon. The majority of these respondents are employed by companies listed on the JSE, which could be a concern if these companies have not publicly explained the extent of their adherence to the King III principles.

Based on the results of the study, financial risks, key activities and processes, as well as regulatory, operational and strategic risks, were identified as the factors most often considered to be part of the combined assurance process. Statistically significant differences were found to exist between the perceptions of respondents from organisations that had implemented a combined assurance process and had mature ERM processes, and those who were from organisations that were in the process of implementing combined assurance and ERM processes. Nearly all features within a combined assurance process (as identified in the literature review), were perceived to be of importance, except for the frequent updating (monthly, quarterly or bi-annually) of the process, and the need for the remedial plan to be approved by the board. Respondents from organisations in the process of implementing combined assurance deemed the identification of assurance providers and the need to assess excessive assurance coverage to be of higher importance than did those with an established combined assurance process. Conversely the results further indicate that these respondents placed the importance of the audit committee and the risk management function within their organisations to provide assurance on the effectiveness of the combined assurance process at a lower level than those who had an established combined assurance process. All respondents believed that a combined assurance process does hold benefits for their organisations, especially to coordinate assurance that focuses on key risks; but as indicated above, statistically significant differences were found to exist between views of respondents from organisations that have already established combined assurance and ERM processes and those in the process of implementing such processes.

Combined assurance became mandatory in 2010 and is therefore still relatively new in South Africa. A future study on the combined assurance process could provide further insights into advancements in the combined assurance process, once combined assurance processes have matured. A future study focusing on identifying the requirements or needs of the board / audit committee pertaining to combined assurance could provide valuable insights into what makes combined assurance effective from their point of view. A further suggestion for a future study is to focus on the responsibilities of combined assurance's key role players (board, audit committee, internal and external assurance providers). Lastly a future study of the advantages of combined assurance, or a cost/ benefit analysis could be valuable to determine if combined assurance is a financially worthwhile exercise for organisations to undertake.

ENDNOTE

1 Chief audit executive is a generally accepted term used in the international internal audit standards to describe a senior official responsible for the internal audit department / the head of the internal audit department (IIA 2012a:19).

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ANNEXURE A: FEATURES IN THE COMBINED ASSURANCE PROCESS

Nr	Responsibility
1	Defining the requirements of combined assurance
2	Assigning responsibility for the implementation of the combined assurance model
3	Assigning responsibility for the maintenance of the combined assurance model
4	Assigning responsibility for overseeing combined assurance
Assurance providers	
5	Identifying various assurance providers
6	Assessing the quality of assurances provided
Assurance and risk mapping	
7	Determining the assurance coverage needed from various assurance providers
8-11	Relating assurance provider coverage to the organisation's risks: Financial, operational, regulatory, strategic
12	Assessing the coverage of risks for completeness
13	Assessing the competence of assurance providers in relation to risks mapped
Checks in the process	
14	Assessing assurance coverage for gaps
15	Assessing assurance coverage for excessive assurance
16	Assessing assurance coverage for duplication in assurance
17	Compiling a remedial plan to address shortcomings
18-19	Approving the remedial plan by the: Board and audit committee
20	Tracking the remedial plan to ensure actioning
Monitoring and reporting	
21	Reporting on assurance provided for significant risks
22	Reporting on exceptions / red flags
23	Reviewing the combined assurance process
24-27	Updating the combined assurance process to evolve with the organisation's strategic objectives: monthly, quarterly, bi-annually or annually.

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Evolving Research

Dimensions for the assessment of ethical leadership: An internal audit perspective

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ABSTRACT

Ethical leadership is regarded as the key to building trust and sustaining organisations. However, monitoring the effectiveness of organisations in promoting ethical leadership poses a challenge to assurance providers, in particular internal auditors. Although attempts have been made to provide internal auditors with guidelines on how to assess the tone-at-the-top, these efforts are still based on the traditional compliance approach that in the past has fallen short of expectations when applied to questions of ethics. This paper proposes additional dimensions, to be included in a value-based approach to the assessment of ethical leadership. The foundation on which these dimensions are assessed is the Integrated Control Framework prepared by The Committee of Sponsoring Organisations of the Treadway Commission (COSO).

Key words

Ethical leadership; internal control; control environment; internal audit; corporate governance; dimensions

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Individuals do not learn values from 'society' but rather from members of their immediate social networks such as leaders and their work teams (White & Lean 2008:766).

1 INTRODUCTION

The subject of ethical leadership has been the topic of numerous research papers, particularly after the series of corporate scandals which occurred during the first few years of the 21st century (Dorasamy 2010; Brown, Trevino & Harrison 2005; Trevino, Brown & Hartman 2003). This interest in ethical leadership intensified during the economic meltdown induced by the sub-prime mortgage crisis and other financial scandals, such as the excessive remuneration of financial services executives and traders (Lehman Bank; AEG; Bank of Scotland) (Kaptein & Avelino 2005:45/46; Soltani 2014:252). In South Africa, action taken by the Competition Commission against some of the leading companies within the construction and bread industries has demonstrated that, despite the presence of other internal control principles, the absence of a strong ethical culture within organisations may lead to serious reputational and financial consequences (Wits 2014; Sunday Independent 2013; Daily Maverick 2013; Moneyweb 2013).

Although there is some level of consensus that the corporate scandals that induced the collapse of many organisations, including public service institutions, can be attributed to the absence of ethical leadership (Soltani 2014; Goodpaster 2007; Brown & Trevino 2006; Knights & O'Leary 2005), there are very few studies that address the development of practical ethical frameworks which can guide leaders and those who are tasked with monitoring activities, particularly internal auditors (Yukl, Mansud, Hassan & Prussia 2013; Wilkinson & Plant 2012; IIARF 2011). Consequently, there are very few instruments that can be used to evaluate and measure ethical culture within organisations (Huhtala, Feldt, Lamsa, Mauno & Kinnunen 2011; Kaptein 2008). Increasingly, there is an appreciation within the field that managers are the critical role models who represent ethical behaviour within organisations (Huhtala *et al* 2011; Brown *et al* 2005) and that substantial attention from management is necessary to create an ethical environment conducive for ethical norms to be developed and embedded (Huhtala *et al* 2011:232).

Various public bodies, like the National Commission on Fraudulent Financial Reporting (more frequently known as the Treadway Commission) (1987) in the United States of America (USA), the Cadbury Committee (1992) in the United Kingdom (UK) and in particular, the King Commission on Corporate Governance in South Africa (IoD 1992; 2002; 2009), have issued reports and recommended measures that, if implemented, would promote ethical leadership and make leaders of organisations more accountable for the good governance of their organisations. Some governments, like the USA, went further and introduced legislation that specifically enforces compliance by corporations, such as the Sarbanes-Oxley Act of 2002 (Rockness & Rockness 2005:31).

Internal auditing is increasingly being regarded as able to play an important role in providing solutions to ethical and corporate governance issues within organisations (Coram, Ferguson & Moroney 2008; Gramling, Maletta, Schneider & Church 2004). Internal auditors are also expected to actively support the organisation's ethical culture (IIA 2012b). One of the key steps in assessing the governance processes and recommending areas for improvement in ethics and values within organisations, as demanded by the Institute of Internal Auditors' (IIA) *Standard 2110: Governance,* is the assessment of the ethical climate within organisations (IIA 2012a). In South Africa, the role of internal audit in providing assurance on the governance, ethics and integrity of corporations was clarified and enhanced through publication of the three King Reports, and particularly the third report, *King Report on Corporate Governance for South Africa* 2009 (IoD 2009).

2 OBJECTIVE AND SIGNIFICANCE

This paper proposes dimensions to be considered by internal auditors as part of a value-based approach to assessing ethical leadership. The paper draws on literature from the fields of ethics, corporate governance, organisational design, and people management to identify relevant dimensions. These dimensions are then considered against the five principles constituting the Control Environment Component of the Committee of Sponsoring Organisations' (COSO) Integrated Framework for Internal Control (COSO 2013), which make up the building blocks of a value-based approach.

The dimensions identified in this paper provide some answers to internal auditors and other assurance providers on how to address the difficulties of conducting a value-based assessment of ethical leadership. The study could also be useful to the IIA in providing further guidance that would augment the existing practice guides. The study forms a basis for future research into value-based measurement of ethical leadership, an aspect that will be useful to management, oversight bodies and other stakeholders.

3 LITERATURE REVIEW

The next section discusses the existing research on ethical leadership and how it impacts on organisations, in particular the working environment, corporate governance, and internal control. The control environment, being the first and critical component of internal control, is the main focus area. The section also explores the role of internal auditors.

3.1 Ethical leadership

Brown and Trevino (2006:595/596) define ethical leadership as the promotion of suitable conduct to followers through personal actions, the management of interpersonal relationships, communication, and decision-making. This definition was a refinement of the definitions offered by, among others, Trevino, Hartman and Brown (2000), and Brown *et al* (2005), who submitted that ethical leadership is a combination of the 'moral person' and the 'moral manager' as it integrates traits, characteristics and motivation with particular actions intended to influence the conduct of subordinates.

To put ethical leadership into context, several other leadership definitions have been considered. Transformational leadership, authentic leadership and spiritual leadership were identified as having strong links with ethical leadership (Brown & Trevino 2006). Transformational leadership is defined by Bass and Steidlmeier (1999) as leadership that inspires and stimulates followers by uplifting their morale, motivation and ethics, while Engelbrecht, Van Aswegen and Theron (2005:20) link transformational leadership to altruism (the desire to help and advance others without expecting personal benefit or reward) and ethical climate (an environment of shared perceptions of what is right and what is wrong). Authentic leadership is defined as decision-making and behaviour guided by high ethical standards and self-awareness, and the demonstration of consistency of and coherence between values, beliefs and actions (Walumbwa, Avolio, Gardner, Wernsing & Peterson 2008:93). Brown and Trevino (2006) describe spiritual leadership as leadership that embraces religious and ethical values, including integrity, honesty, humility, reliability and amiability. The movement in the current complex business environment is towards transformational ethical leadership, as this type of leadership is perceived to be most suited to advancing sustainability efforts within organisations (Avolio, Bass & Jung 1999).

Haubold and Throneberry (2010:33) assert that leaders might be oblivious of the influence they have on their organisations. They claim, further, that the integrity and values of leaders are responsible for setting the parameters of employees' ethical conduct, going on to argue that if top management flaunts ethical principles and organisational rules and procedures, there will be a strong possibility that employees will model this behaviour (Haubold & Throneberry 2010). Kaptein and Avelino (2005) arrive at a similar conclusion and state that ethical leadership is supposed to set a good example for employees as well as stimulate their good conduct. The ethical conduct of corporate leaders has therefore increasingly been identified as critical to the ethical conduct of employees (Huhtala *et al* 2011; Brown *et al* 2005).

The link between the integrity of leaders and the ethical behaviour of employees has been identified by White and Lean (2008:774), in their deduction that the effectiveness of leaders is optimised when they demonstrated values – such as integrity, equity, fairness and respect, – that were consistent with the expectations of employees. White and Lean (2008:774) also asserted that leaders' behaviours are likely to influence organisational effectiveness, team performance and employee commitment to the organisation. The impact of leaders on employee performance has been further explored by Bello (2012) and Lasthuizen (2008), who indicate the importance of leadership in influencing employee integrity. Shaw, Erickson and Harvey (2011) and Maguad and Krone (2009) argue that there is a link between moral leadership and the improvement of quality within organisations. The opposite, termed destructive leadership by Schyns and Schilling (2013), may encourage counterproductive behaviour within the work environment. De Hoogh and Den Hartog (2008) also confirm that there is a positive link between ethical leadership, top management team effectiveness, and subordinates' optimism about the future and their own place within that future.

The social learning theory of organisational ethics, propagated by Brown *et al* (2005), explains that leaders can only be perceived as ethical by their followers if they are attractive and credible role models. Brown and Trevino (2006:598) extend this and argue that the way leaders reward and punish their followers influences ethical behaviour, as followers learn through direct observations as well as vicariously, through second-hand information. Kaptein and Avelino (2005:53) also submit that by creating a culture of openness and transparency, while increasing management sensitivity to the impact of organisational structure, ethical climate, and ethical culture on behaviour, ethical leaders would be satisfying the major requirements for improving ethics within organisations.

The point of departure for any governance system is the question of where the leadership is located. Some systems propose that leadership rests with the board of directors, while others consider it to be the role of the executive management, and yet others believe it to be a combination of both of these distinctive leadership roles (Ocasio 1994; Carcello, Neal, Palmrose & Scholz 2011). Consequently, there is a diversity of leadership theories relating to whose interests are being served within which particular environment. Some of these arguments are supportive of the agency, stakeholder, and stewardship theories (Caldwell & Karri 2005; Thoms 2008; King 2006). As early as the nineteen-nineties, researchers had begun to examine the relationship between social performances and financial performance, with increased emphasis being placed on the wider stakeholder universe, as opposed to the conventional, narrow focus on the shareholders (Verschoor 1998). This approach contributed to increased attention being given to the utility of the code of conduct. However, it was soon realised that, without senior leadership personally demonstrating full commitment, a stated commitment to the ethical principles reflected in the typical code of conduct would be nothing but a public relations exercise (Thoms 2008:437). Previously, Verschoor (1998) argued that it would be critical for organisations to focus on the effectiveness of controls that have been designed to ensure commitment to ethical and socially-responsible behaviour.

The focus on the ethics-related controls is supported by Goodpaster (2007), who classifies markets and laws as external controls and conscience as an internal control. Goodpaster (2007) and Yukl *et al* (2013) also argues that, since the demise of many organisations had resulted from the drive to achieve goals at all costs, and the rationalisation of this method, the sustainable approach would be to align ethical aspirations with rewards, incentives, and discipline, as well as to carry these into internal and external communications in the day-to-day operations of organisations. If by personally demonstrating the values of the organisation through their conduct, be it during daily activities or during pressure or crisis situations (this results in more ethical behaviour by their subordinates), the leaders would be confirming the validity of the social learning theory (Zhu 2008).

3.2 The Control environment

The COSO Framework, published in May 2013, describes the control environment as the foundation and anchor of the ethics climate because it sets the tone-at-the-top (COSO 2013). Tone-at-the-top is an important factor in determining the role played by internal controls and the expected conduct within the organisation (COSO 2013). The control environment is defined as the standards, processes and structures that are developed and reinforced by management to ensure that internal controls are implemented and supported across the organisation (COSO 2013). COSO (2013) furthermore indicates that the control environment is influenced by both internal and external factors, and that to be resilient, an organisation needs to establish and maintain a strong control environment.

There are indications that a strong control environment is critical for an effective system of internal control, as envisaged by the COSO Framework (Schneider & Becker 2011). In supporting this assertion, Soltani (2014) identifies the following as the main causes of recent high profile European and American corporate scandals: ethical dilemmas, ineffective boards, inefficient corporate governance, dominant CEOs, dysfunctional management behaviour, and weak (off-key) tone-at-the-top. Haubold and Throneberry (2010) agree with this view, arguing that the implementation of formal controls will not be sufficient to prevent fraud and that, rather than relying exclusively on formal controls, organisations should consider informal controls as part of their fraud-mitigation approach. Haubold and Throneberry (2010: 30) further posit that ethical leadership and accountability play a significant role in countering any emerging 'sense of entitlement' within organisations. Bederd (2011) also supports the argument that the tone-at-the-top is the most important line of defence in the deterrence of fraud.

As one of the components of the internal control universe, there is a perception that internal auditors are usually pre-occupied with risk assessment, control activities, information and communication, and monitoring activities, at the expense of the wider control environment (Geiger, Cooper & Boyle 2004). The suggested approach is thus to conduct cultural audits that focus on assessing the tone-at-the-top (Callaghan, Savage & Mintz 2007; Castellano & Lightle 2005). This approach is supported by Kaptein and Avelino (2005), who confirm the significance of the relationship between organisational climate and unethical behaviour, and further recommend the regular monitoring of management integrity. Kaptein and Avelino (2005:53) also suggest the use of an employee survey as a means of evaluating the effectiveness of the control environment. Wilkinson and Plant (2012) are in favour of extending the scope of the internal audit functions beyond compliance reviews, in order to incorporate the assessment of organisational governance through a governance maturity model.

3.3 The role of the internal audit

Holmes, Langford, Welch and Welch (2002:96-97) theorise that employees will display organisational citizenship behaviour (OCB) in environments where senior management demonstrates a strong support of ethical behaviour. In the same article, Holmes *et al* assert that internal control systems should not only refer to financial and operational information, but should also include ethical behaviour 'control' by top management (2002:96-97). In their interpretation of OCB, Holmes *et al* (2002:86) include behaviours such as altruism (helping others), courtesy (respecting others at work), sportsmanship (accepting or over-looking some irritations), civic virtue (putting the community first), and conscientiousness (behaviours that put the organisation first). The ethical leadership dimensions referred to by Holmes *et al* (2002), go far beyond adherence to formal rules and standards. The role played by auditors, both external and internal, during the publicised corporate scandals has demonstrated the difficulties auditors face in evaluating and reporting on the control environment, possibly due to the informal nature of the organisational climate and the limited availability of tangible evidence (Martin 2007:9). This requires a consideration of the wider body of stakeholder interests, as envisaged by Sikka (2009:868) and Richard, Baker & Owsen (2002: 785), who believe that, given the current societal dynamics, the role of auditors should be reconstructed.

The combination of monitoring compliance with legislation and the reviewing of control activities has always been proposed as the most effective approach to ensuring effective systems of internal control for financial reporting, including the prevention and detection of fraud (Rae & Subramanian 2008). However, the shortcomings of this approach as the sole deterrent against unethical behaviour have also been identified by Rockness and Rockness (2005), Kayes, Stirling and Nielsen (2007) and Michaelson (2006); their research provides some insight into the limitations of compliance in addressing unethical behaviour and generally supports the notion that, in order to ensure a strong ethical environment, it is necessary to go beyond rules and regulations. The limitations of the regulatory approach, highlighted by Lail, Macgregor, Stuebs and Thomasson (2013), suggests that, in order to influence the tone-at-the-top, it is best to integrate a compliance-based approach with an empowerment-based approach.

Although Arel, Beaudoin and Cianci's assessment of the impact of both ethical leadership and internal audit (2012:362) focuses on financial reporting they nevertheless found evidence of a significant conflation of the influences of internal audit and ethical leadership, and conclude that the assessment of moral intensity was as critical as the assessment of the effectiveness of internal controls. Focusing on internal controls and the perceptions of internal auditors, Fourie and Ackermann (2013:37) conclude that the principles of internal controls that make up the control environment component in the COSO Framework (COSO 1992; 2013) are in fact crucial to the effectiveness of internal control and that internal auditors should thus prioritise the evaluation of these principles during their audit activities.

It is against this background that the IIA, in an attempt to assist internal auditors' efforts to evaluate the tone-at-the-top, published two relevant and instructive guides - 'Auditing of the Control Environment' (IIARF 2011) and 'Assessing Organisational Governance in the Private Sector' (IIARF 2012a). However, these practice guides focus on identifying formal governance and management processes/practices, with emphases on documentation and mandatory requirements (either compelled by legislation or self-regulatory) (IIARF 2012a; 2011). This may fall short of embracing the empowerment-based approach advocated by Lail *et al* (2013). Although these two IIA practice guides (IIARF 2012a; 2011) may contribute significantly to creating awareness of the role played by internal auditors in assessing the tone-at-the-top, their compliance bias may render them inadequate to the task of addressing the behavioural dimensions identified by Holmes *et al* (2002).

The IIA acknowledges that auditing the control environment implies evaluating 'soft controls', a process that may render some of the current and long-established testing approaches ineffective, but does not provide sufficient guidance to internal auditors on how to gather evidence relating to these soft controls, in that it simply recommends that auditors should apply 'outside the box' techniques (IIARF 2011).

Interestingly, Rouillard and Giroux (2005) take a completely contrary position, drawing attention to the unintended consequences resulting from over-emphasis of ethics and values, particularly in public administrations. In their opinion, this over-emphasis may cause confusion and an undesirable shift from a 'disciplinary society' to a 'control society' (Rouillard & Giroux 2005:333). Their viewpoint may require further exploration through future studies.

The duty of internal auditors is to continuously employ methods that will improve professional judgement (Ruud 2003). The difficulty in providing solid professional judgement while evaluating the control environment, is that the control environment is not transaction-oriented and as such the usual substantive tests, walkthroughs, and the repeated performance of transactions may not be useful (Castellano *et al* 2005; Ramos 2004). While arguing for the expansion of ethics audits beyond compliance to a more holistic integrity approach, Plant (2008:23) suggests the use of surveys, focus groups, and interviews as effective and appropriate methods to gather information from relevant stakeholders.

Although there are various well-proven methods (including interviews, focus groups, desktop research, data analytics and the examination of objective historical data) that can be used to assess ethical leadership within organisations, Kalshoven, Den Hartog and De Hoogh (2011) and Kaptein and Avelino (2005) suggest that monitoring organisational integrity through people surveys and multidimensional questionnaires may assist in evaluating the quality of ethical leadership. This is because surveys are efficient, can be kept confidential and, most importantly, the data generated can be readily compared with other sets of data.

To ensure that the quality of leadership is meaningfully determined, analysis of the impact of the organisational ethical culture on managers and employees and, critically, the impact of the conduct of managers and employees on the organisation, should be conducted through these surveys and questionnaires. This is more effective than relying on box-ticking exercises, the presence of a code of conduct, the auditing of compliance levels, and analysing statistics of fraud and disciplinary cases (Kalshoven *et al* 2011:51-52; Kaptein & Avelino 2005:47).

As a minimum, internal auditors are expected to conduct period assessments of the ethical climate, both enterprise-wide and for specific audit projects, using employee surveys (IIARF 2012b). However, in certain situations, internal auditors may rely on, and use the results generated by other service providers/ experts that may have conducted these types of surveys; but it will still be incumbent on the internal auditors to have the capability to evaluate the relevance and effectiveness of the surveys for use as a basis for their professional judgement (IIARF 2012b). Furthermore, internal auditors are encouraged to work closely with the organisation's ethics office in order to be able to provide assurance to the ethics committee and/or audit committee on ethics-related matters, including ethical leadership (Dobie & Plant 2014:9).

4 METHODOLOGY

The study on which this article is based consists of a review of academic literature covering a range of disciplines, including internal auditing, ethics, governance, organisational design, and people management. A limitation of this study, which is also an area that has been identified for future research, is its basis on a literature review only, with no empirical results to enhance its contribution. The literature review was conducted in order to identify the dimensions of ethical leadership which could be used by assurance providers when assessing ethical leadership. The method applied in this study for identifying these dimensions is discussed in the subsequent sections.

4.1 Dimensions foundation

COSO (2013) defines the control environment as … "those standards, processes and structures that allow or trigger the implementation of internal controls". In other words, internal controls thrive in a favourable control environment. Noland and Metrejean (2013:98) regard the control environment to be the umbrella under which the other components thrive, as it represents the attitudes of an organisation's top executives.

The COSO Framework also classifies internal controls into three (3) objectives (operations, reporting and compliance), five (5) components (control environment; risk assessment; control activities; information and communication; monitoring), information and communication, and monitoring activities, and seventeen (17) principles. The methodology used for this paper focuses primarily on the first component of internal control, namely the control environment and its five principles, as outlined below.

In the IPPF Practice Guide on auditing the control environment, the IIARF (2011) uses six elements that are very similar to the five principles of the COSO Integrated Framework (COSO 2013), as illustrated in the comparative table below.

Table 1: Comparison between control environment principles of the COSO framework and the IPPF practice guide

COSO control environment	The IIA's IPPF practice guide: Auditing the control environment
Integrity and ethical values	Integrity and ethical values
Independence and oversight	Management philosophy and operating style
Structures, reporting lines and delegations	Human resource policies and practices
Assignment of authority and responsibility	4. Assignment of authority and responsibility
Recruitment, development and retention of competent individuals	5. Competency of personnel
	6. Organisational structure

Source: COSO (2013); IIARF (2011)

Considering these similarities, a combination of the principles of the COSO Framework (COSO 2013) and the IIA Practice Guide (IIARF 2011) was used as the foundation for positioning those dimensions identified as essential for inclusion in an assessment of ethical leadership as a value-based approach. These dimensions were published in earlier research by King (2006:123), Kaptein (2008:924-927), Kalshoven *et al* (2011:54) and Resick, Hanges, Dickson and Mitchelson (2006:346).

Once selected, the ethical leadership dimensions were then grouped together according to interpretation, and their implications for the internal audit function were identified. Having identified the relevant implications of the ethical leadership dimensions, they were then evaluated against the general objectives of the five principles of the control environment (COSO 2013) and the six elements of the IPPF's Practice Guides (IIARF 2011) (see Table 1). To ensure simplicity, the paper only focuses on those dimensions that are mentioned by two or more studies, or that can be aligned or consolidated with other dimensions. Although the dimensions which do not meet these criteria are also regarded as relevant, their implications were not identified and therefore not considered for this study.

4.2 Identifying dimensions to assess ethical leadership

The four abovementioned studies have been chosen to demonstrate the complex nature of ethical leadership dimensions, as well as their similarities, and their differences, as outlined in Table 2 below. The implications of these dimensions for the internal audit activity and the control environment have also been discussed above. These studies were considered because they explore ethical leadership dimensions from different perspectives, namely corporate governance (King 2006), ethics (Kaptein 2008) and organisational behaviour (Kalshoven *et al* 2011; Resick *et al* 2006).

Table 2: Dimensions relating to ethical leadership

King (2006)	Kaptein (2008)	Kalsoven *et al* (2011)	Resick *et al* (2006)
Fairness	Clarity	Fairness	Character & integrity
Accountability	Congruency	Power sharing	Community/ People orientation
Responsibility	Feasibility	Role clarification	Motivating/ Encouraging/ Empowering
Transparency	Supportability	People orientation	Ethical awareness & accountability
Intellectual honesty	Transparency	Ethical guidance	
	Discussability	Environment Orientation	
	Sanctionability	Integrity	

Source: (as indicated)

5 DISCUSSION ON RELEVANCE OF DIMENSIONS

There are obvious similarities between the studies, like fairness (Kalshoven *et al* 2011; King 2006), transparency (Kaptein 2008; King 2006), people orientation (Kalshoven *et al* 2011; Resick *et al* 2006), accountability **(**King 2006; Resick *et al* 2006) and integrity (Kalshoven *et al* 2011; Resick *et al* 2006). Some dimensions may be aligned to others through definitions and interpretations: for example, intellectual honesty (King 2006) shares similarities with character (Resick *et al* 2006).

5.1 Fairness

Both King (2006) and Kalshoven *et al* (2011) consider fairness as a dimension. King (2006:123) defines fairness as including those decisions that will allow the company to be perceived as a decent organisation and its business activities to be accepted as legitimate. Kalshoven *et al* (2011:53) define fair leaders as those who make principled and fair choices and who do not practice favouritism. In support of the dimension of fairness, Rae and Subramanian (2008) were able to positively link the quality of internal procedures to the perception of organisational justice and occurrences of employee fraud but, more significantly, they also established a link between the quality of internal control procedures, the organisational ethical environment, and internal audit activity. These findings point towards the inclusion of fairness as a dimension to be considered in an assessment of ethical leadership as part of a value-based approach.

5.2 Transparency

King (2006:123) defines transparency as the act of communicating important decisions truthfully and promptly, while ensuring that substance rather than form is communicated. Kaptein's definition (2008:926) focuses on employee awareness of the consequences of their actions and of the visibility of their actions to management and vice versa. Rockness and Rockness (2005) conclude that it is only when a strong organisational culture is combined with controls, legislation, rewards and sanctions, that an ethical and transparent financial reporting approach can be fostered. Ethical leaders therefore consider transparency as one of the key dimensions of the organisational culture.

5.3 People orientation

Kalshoven *et al* (2011:53) define people orientation as the demonstration of genuine concern for people, providing support for people, and making every effort to meet their needs. Resick *et al* (2006:347) consider people orientation to be the use of social power to serve the collective interests of others, instead of serving solely the interests of the organisation. As a corporate governance mechanism (Cooper, Leung & Wong 2006:828), the internal audit activity should also consider people orientation as a critical dimension to assessing ethical leadership as part of a value-based approach.

5.4 Accountability, responsibility and role clarification

Accountability is described as being accountable to the organisation that one represents, and setting ethical standards of conduct within the organisation (King 2006; Resick *et al* 2006). Both the COSO Framework (COSO 2013) and the IIA Practice Guide (IIA 2011) propose formal organisational structures, reporting lines, and the assignment of authority and responsibility as key to the effectiveness of the control environment (refer to Table 1). This implies that these three dimensions - accountability, responsibility, and role clarification - should be considered in the assessment of ethical leadership as part of a value-based approach.

5.5 Integrity and congruency

Integrity is described in the literature as the alignment between words and deeds (Kalshoven *et al* 2011:53), or the ability to do the right things despite external pressures (Resick *et al* 2006:346). Kaptein (2008) describes congruency as the consistency achieved with the alignment of management behaviour with organisational expectations. The promotion of integrity and ethical values as a key ingredient of the tone-at-the-top is mentioned in both the COSO Framework (COSO 2013) and the IIA IPPF Practice Guide (IIA 2011). As ethical values, integrity and congruency should be included as dimensions to be considered in an assessment of ethical leadership as part of a value-based approach.

5.6 Ethical guidance and ethical awareness

Ethical guidance as defined by Kalshoven *et al* (2011:53) is the process of communicating ethics, the presence of ethical rules, and the promotion of and reward for ethical conduct. Resick *et al* (2006:347) posit that ethical awareness is evident when leaders display and encourage ethically appropriate behaviour. The communication and monitoring components provide for the evaluation of formal ethics programs (beginning with the code of conduct and including the education and awareness campaigns), and are both specified by the COSO Framework (COSO 2013) and the IPPF's Practice guide (IIARF 2011). Ethical guidance and ethical awareness could thus be regarded as important dimensions to be considered in an assessment of ethical leadership.

6 CONCLUSION

Numerous studies have focused on ethical leadership and its influence and impact on organisational culture, performance and employee productivity; however, very little effort has been applied to identifying dimensions that will assist assurance providers (and internal auditors in particular), in assessing the state of ethical leadership within organisations. The literature supports the view that a strong control environment is critical for an effective system of internal control, and demands an ethical tone-at-the-top.

Although the COSO Framework (COSO 2013) outlines the principles that underpin the tone-at-the top as a component of the control environment, there is very limited research on how this sensitive area can be assessed and reported on by assurance providers, without reducing it to a mere compliance exercise. The IIA has provided guidelines to internal auditors for conducting audits that can assess the overall culture of the organisation as represented by the control environment. The IIA guidelines refer specifically to the tone-at-the-top, as reflected by the integrity and ethical values, management philosophy, operating styles, policies and procedures, structure, competence and accountability of its leaders. Although representing a commendable start, these guidelines still limit the assurance exercise to one of assessing compliance with the principles, and are not extensive enough to encourage a value-based approach.

The identification of ethical leadership dimensions to be included in the assessment tool for ethical leadership will enable internal auditors to follow a value-based approach. These dimensions, which have been identified with support from the literature, include fairness, transparency, people orientation, accountability, responsibility and role clarification, integrity and congruency, and ethical awareness. The relevance of these dimensions for internal audit activity was discussed. The proposal of these dimensions is a basic step that should ignite further research and the development of further phases that can be enhanced and tested for effectiveness. Further consolidation and testing of these ethical leadership dimensions will provide a sound basis for the development of an ethical maturity framework. This process could then culminate in a focused ethical leadership maturity framework that contributes to the effective assessment of the values necessary to drive organisations towards an integrated, sustainable ethical culture, as opposed to the current adherence to the minimum reporting requirements.

Future research should also focus on the extent to which internal auditors currently evaluate the control environment and ethical leadership in their audit activity. Furthermore, whether internal auditors possess the necessary skills to evaluate the control environment beyond compliance, particularly the evaluation of the ethical climate and the presence of ethical leadership within organisations, needs to be determined.

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Internal audit in state-owned enterprises: Perceptions, expectations and challenges

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ABSTRACT

State-owned enterprises are critical vehicles for the delivery of goods and services, and can contribute to the sustainable economic growth of developing countries. The business environments in which these state-owned enterprises operate pose risks to the enterprises, which then rely on internal audit, amongst other options, to managing these risks. The objective of this study was to determine the perceptions of, expectations for and challenges experienced by internal audit functions in today's state-owned enterprises. A qualitative research approach was selected, utilising a case study method, and data was collected through interviews with important role players associated with the internal audit function of three South African state owned enterprises.

The findings of the study revealed that internal audit functions are perceived in a positive light and that participants do place reliance on internal audit. The internal audit functions act as business partners to management, and expect support from the audit committees and management in terms of ensuring the internal audit functions' independence, and the provision of required resources and skills. The internal audit functions face diverse challenges. These relate to the relative novelty of performance auditing and combined assurance in state-owned enterprises, the differences in methodologies and auditing systems used by outsourced functions, repeat (negative) audit findings, a lack of business knowledge and insight on the part of the entity, and non-compliance with quality assurance and improvement Standards.

Key words

State-owned enterprises; internal audit function; chair of audit committees; chief audit executive; risk management; emerging risks; internal audit skills

1 INTRODUCTION

The ongoing water crisis in Gauteng and the national electricity crisis during the latter half of 2014, and the resultant public outcry, focused attention on the critical need for reliable basic services to the general public, businesses and industries, and on the greater South African economy's dependence on them (Faku 2014; Mapumulo 2014; Fin24 2014). The situations emphasised the critical importance of state-owned enterprises (SOEs) as strategic providers to all sectors of the economy, thus clearly demonstrating the relevance of SOEs in emerging economies, particularly where they operate in strategic sectors with responsibility for the provision of services that are deemed to be of national interest (Aproskie, Hendriksz & Kolobe 2014:2) and fundamental to the government's development agenda (Ngonini 2014: 406).

A large number of SOEs in South Africa effectively operate as private sector companies and depend on international markets for funding (Adam 2013:166). These SOEs have to adhere to sound corporate governance principles. The need for SOEs is well explored in the literature (Fourie 2001:206; PwC & IoDSA 2011:2); however, literature on internal audit in SOEs is scarce. Okibo and Kamau (2012:109) show that management and the audit committee expect internal audit in SOEs to evaluate and improve risk management, but the role of an SOE's internal audit function (IAF) in a developing economy such as South Africa remains unexplored. This results in a gap in the literature, and the objective of the study reported in this article is to address this gap. This study thus aims to obtain an understanding of the role of IAFs in SOEs in a developing economy. This has been done by determining the perceptions and expectations of, and challenges experienced by IAFs in today's SOEs.

The study adds substantially to the current body of knowledge, as limited research has been done on internal audit within SOEs. The focus of this study is SOEs which, in developing countries such as South Africa, form the backbone of the economy (Octavia 2013:77; Balbuena 2014:6). SOEs are facing challenges because the business environment in which they function is changing due to accelerated globalisation and advancements in technology (Crosby 2014:47;

Hass, Adolmohammadi & Burnaby 2006:835). The current economic downturn resulting from the financial crisis is also taking its toll (Beasley, Branson & Hancock 2010:29), because external funding opportunities for SOEs are decreasing.

As it is a relatively under-explored topic, a study of the role of internal audit in a SOE could beneficially inform the executive and middle management of SOEs on how internal audit can assist them to overcome challenges they face in their complex operating environments. Similarly, internal auditors of SOEs could benefit by benchmarking their roles and responsibilities against those reported in the article. Lastly, the study could benefit the Institute of Internal Auditors (IIA), as the IIA could use the findings of the study to inform future guidance on internal audit in SOEs.

The next section presents an overview of the literature study component, and is followed by an explanation of the research methodology. Thereafter findings from the study are presented, and, after the conclusion, recommendations are made and areas for future research are identified.

2 LITERATURE REVIEW

SOEs are created to deliver strategic goods and services to the country's citizens (PwC & IoDSA 2011:2), thereby contributing to improving the standard of living of the population (Fourie 2001:206). Strategic goods and services include the delivery of electricity, transportation (Thomas 2012:449), and water and sanitation (Balbuena 2014:6; Vaglasindi 2008:2). SOEs focus on the economic development of infrastructure and utilities (Balbuena 2014:6) in these strategic sectors. This serves as a clear demonstration of the relevance of SOEs in emerging economies, where SOEs are responsible for the provision of strategic services that are deemed to be in the national interest (Aproskie, *et al* 2014:2) and fundamental to the government's developmental agenda (Ngonini 2014:406). SOEs support the government in addressing matters of social and economic transformation, and in closing the gap between rich and poor, and rural and urban populations (PRC 2013:7). In developing countries these strategic sectors need to expand in order to support economic growth and social development goals (NDP 2011:161), and their operational well-being is dependent on external funding, other than from government, particularly for capital investments. To achieve this, SOEs seek (and are required) to emulate private-sector governance practices while retaining full state ownership (Frederick 2011:9).

Business environments in which SOEs function are characterised by changes brought about by advancements in technology (Crosby 2014:47: Hass *et al* 2006:835), by global competition for access to international markets (Allen & Mawn 2011:31; Mintz & Krishnan 2009:60), and complex financial instruments (Odoyo, Omwono & Okinyi 2014:169) needed to compete for investor funding (Maharaj, Hei & Van Rensburg 2006:19). All of these changes bring about uncertainties and exposure to related risks, which are sometimes perceived as "emerging economy risks" (Chambers & McDonald 2013:4). Such an environment demands effective corporate governance systems (Taufiqurrahman 2011:31; Mintz & Krishnan 2009:60) and risk management processes (Schneider, Sheikh & Simione 2011:29; Liu 2012:287) at enterprise level. Previous research on private sector organisations has shown that management and the audit committee rely on internal audit to evaluate and improve risk management (Msiza 2011:27). The same expectation exists for internal auditing in SOEs (Okibo & Kamau 2012:109).

Berg (2010:81) describes risk management as "a systematic approach to setting the best course of action under uncertainty by identifying, assessing, understanding, acting on and communicating risk issues". The literature supports the view that internal auditing has to play a role in risk management (Stewart & Subramanian 2010:345; Hass *et al* 2006:835; Sarens & De Beelde 2006a:71). While acknowledging that risk identification, evaluation and monitoring are the responsibility of top management and the board, internal auditing could nevertheless contribute as consultants and assurance providers on risk management processes and systems (Allen & Mawn 2011:31; Stewart & Subramanian 2010:345), roles which Sarens & De Beelde (2006b:219) deem to be of a supportive nature. They can offer consulting services to help the organisation in identifying, assessing and implementing risk management methodologies and controls to address significant risks (Odoyo *et al* 2014:174; Arena & Azzone 2009:46) by suggesting steps likely to mitigate the consequences of not achieving the organisation's objectives (Turlea & Stefanescu 2009:213).

As the environment in which SOEs function is changing, internal audit is required to proactively adapt to changing business demands (Octavia 2013:79). Yee, Sujan and James (2007:17) regard today's internal auditor as a strategic partner to business, requiring internal auditors to share risk-related insights and analysis prior to strategic decisions being made. Their contribution to risk management, according to Bekiaris, Efthymiou and Koutoupis (2013:63), forms a critical part of an organisation's management function. This is in line with the prediction made by Anderson and Svare (2011:1) that internal auditors will focus on risk management, and governance processes will become the foundation of the internal audit profession. However, as pointed out by Lindow and Race (2002: 28), where there internal audit lacks understanding of the risks faced by the organisation, they will only be able to follow a traditional checklist approach, and will fail to monitor the organisation's risk profile, and to identify risk management processes needing improvement.

Dissenting views have been expressed about internal auditing's evolvement in relation to risk management; for example, Griffiths (2005:45) questions how far internal auditing should go – a valid question which is especially pertinent with regard to addressing emerging risks. Most companies which failed during the 2007/8 economic meltdown did not focus enough on identifying, assessing and managing the emerging risks that ultimately destroyed stakeholder value (McShane, Naira & Rustambekov 2011:641; Marks

2011:2; Beasley *et al* 2010:29). Msiza (2011:27-28) is of the view that internal audit should have played their part by bringing to the fore the risks that compromised the financial sustainability of some SOEs, when they had to request additional funding from banks and the government to continue with their operations. The question therefore remains whether management of SOEs should create an opportunity for internal audit to address this risk-management vacuum.

Although the internal auditing profession believes that as partners to management, internal auditors "are positioned to help protect the organization against both traditional and emerging risks" (IIARF n.d.), a recent Ernst & Young (2013:1) study shows a contrasting view. Only 27% of internal auditor respondents to their survey indicated that they participated fully in identifying, assessing and monitoring emerging risks, whilst 54% were expecting to become fully involved within the next two years (ending in 2015) (Ernst & Young 2013:1).

Some explanations for such low involvement in addressing emerging risks are to be found in the literature, and suggestions have also been made for the changes that are needed in order for involvement to gain momentum. These include suggestions on changes to internal audit practices, the role and responsibilities of internal auditors and their current and future skills sets. Within the limited body of research about internal audit in SOEs, no attention has yet been given to emerging risks. As the focus of this study is to determine the role of internal audit in today's SOEs, its role in relation to emerging risks is explored in relation to the existing literature on private sector entities. SOEs and other organisations are operating in environments characterised by rapid change (due to globalisation and advances in technology), where funding sources have decreased. One could argue that the challenges faced by internal auditors in the private sector correlate well with challenges that internal auditors in SOEs face. This is supported by Van Gansberghe (2005) and Goodwin (2004:648), who claim that internal auditing in the private sector and the public sector is very similar. Thus published suggestions for improvement gathered from the literature, for internal auditors to play a more prominent role in managing emerging risks, would also be relevant for internal auditors in SOEs.

In order for internal audit to assume a more prominent role in identifying the risks that are constantly emerging, the internal audit charter should be flexible enough to allow internal audit to take a proactive and forward-thinking approach (Cavaleros 2013:21; Deloitte 2012:3), and it has to be aligned strategically with the needs and priorities of all stakeholders, including the audit committee and senior management (Piper 2014:30; Hass *et al* 2006:839). The annual audit plan should therefore be adapted to provide for a balance between assurance and advice on strategic business initiatives (Ernst & Young 2013:4).

Internal auditors need to present a forward-looking perspective to top management and the board, highlighting exposures and assisting to prevent disruptions or losses to organisations that could arise should the threats materialise (Accelus, Thomson & Reuters 2013:3; Msiza 2011:28). Tabuena (2012:30 & 31) believes internal auditors not only have to understand the business environment in which their organisations operate, they should also be able to relate the potential impact of the emerging risks to recognised causes, both individually and in combination. Bota-Avram, Pop and Bota-Avram (2009:208) suggest that this could require internal audit to amend its role in the process of risk management into one with a more strategic outcome. Msiza (2011:29) is of the view that the operations of the IAF should be aligned with the changing risk profile of its organisation and the increasing and changing needs of the organisation's stakeholders.

Internal auditors must expand their skill sets in order to meet these demands (Boyle & Boyle 2013:4; Hass *et al* 2006:842). Cavaleros (2013:22) similarly questions whether internal auditors have the requisite skills mix and resources to proactively identify and address emerging risks, as the role of a strategic advisor on emerging risks requires enhanced strategic thinking capabilities (Protiviti 2013:1) and the ability to respond quickly to emerging events (Tabuena 2012:30). The role demands business insights, good communication skills and analytical thinking skills. Tabuena (2012:30) believes that organisations are overly optimistic, expecting the IAF to cultivate skills and to leverage specialists in order to provide support in areas in which it does not have the breadth and depth of expertise to provide the required insight. Boyle and Boyle (2013:8) also identify the need for internal audit to master other attributes, pointing out that for internal audit to obtain access to strategic deliberations, it must be viewed by both senior management and the board as reliable, knowledgeable and trustworthy; and in order to be viewed in this way it needs to demonstrate its willingness to accept the challenge. In order to succeed it is imperative that the IAF be strengthened through allocation of sufficient resources to enable it to attract the required skills.

3 METHODOLOGY

In order to achieve the objective of this study, an understanding of IAFs in SOEs was required and therefore a qualitative research approach utilising a case study method was followed (Hennink, Hutter & Lailey 2011:16; Yin 2011:6; Patton 2002:14). Three SOEs in South Africa were selected, because of the strategic nature of their operations in the country's developing economy: energy, transport and water. In selecting the individual participants for this study, three stakeholders identified by the literature (Sarens, De Beelde & Everaert 2009:90; Goodwin 2003:265) as important role players in internal audit were considered, namely chairs of the audit committees (CACs), chief audit executives (CAEs) and chief financial officers (CFOs). In addition to their organisational importance, they also have a close working relationship; the CAE, as the head of an IAF, reports functionally to the CAC (Cavaleros 2013:20), and many of the services performed by the IAF relate to financial matters under the direction of the CFO (Sarens & De Beelde 2006b:222).

For the three SOEs selected, internal audit in the first is an in-house function; the second is an in-house function with an element of co-sourcing of the specialist areas, while the third has a fully outsourced IAF. This added dimension enabled the study to examine three different forms of IAFs.

The intention was to have interviews with Eskom (representing energy), but as a result of the afore-mentioned electricity crisis this became impossible. Eskom was therefore replaced by a SOE falling under the office of the Presidency that deals with youth development issues. The interviews with all three SOEs were conducted from 10 October 2014 to 12 December 2014.

The limitations of following a case study method are that it could be seen as lacking rigour (Yin 2009:14; Neale, Thapa & Boyce 2006:4) These limitations have been managed in this research by striving to optimise the quality of the research and the validity (Shenton 2004:63) of the data. This was done by ensuring that the study examined what was actually envisioned, and that a correct depiction of the phenomenon under scrutiny was presented (Morrow 2005:251). However, the findings are not generalisable in the conventional sense (Flyvbjerg 2006:219; Hodkinson & Hodkinson 2001:9) as they are not necessarily representative of the wider population of SOEs. Efforts were also made to ensure that the reliability (Seuring 2008:131) of findings was consistent with reality (Patton & Appelbaum 2003:65). These outcomes were largely achieved by utilising guided interview questions (so that a similar line of questioning was applied to all interviewees), and by following a structured approach (recording interviews, having them externally transcribed, communicating with interviewees to review transcripts and analysing the data using ATLAS.ti software). The study was nevertheless based on views of only eight participants from only three SOEs, and so the findings cannot automatically be assumed to have widespread and general applicability.

4 FINDINGS OF THE STUDY

(1) Background

In obtaining an understanding of the internal audit function in today's SOEs, the views held by CACs, CAEs and CFOs of three SOEs in strategic sectors of the economy – namely water, energy and transportation – were sought. As explained above, Eskom had to be removed from the study due to the unavailability of the intended participants, and was replaced by another SOE that does not operate in a strategic sector. It was established through observations and detailed interviews with the participants from this enterprise that when compared with SOEs in the strategic sectors of the economy, the maturity of its IAF was less than that of the enterprises in the strategic sectors, with reference to combined assurance and quality assurance reviews (internal and external), and in terms of the experience and maturity of the CAE heading the IAF.

Of the three SOEs selected, the first SOE has an in-house IAF; the second has an in-house IAF with an element of co-sourcing to address the specialist areas, while the third has a fully outsourced IAF. This enabled the study to address three different forms of IAFs. As indicated earlier, the CAEs, CFOs and CACs of the selected SOEs were invited to participate in the study. Table 1 shows the participants in the study.

Table 1: Participants in the study

SOE	CAE	CFO	CAC
SOE 1	1	1	1
SOE 2	1	1	1
SOE 3	1	1	0
*Eskom	1	0	0
Total	4	3	2

**Eskom was replaced by another SOE because of unavailability of participants as a result of the electricity crisis.*

Eight interviews were conducted with the participants identified above. Participants were classified as follows: category A (CAEs), category B (CACs) and category C (CFOs).

The data was transcribed from the interviews' audio recordings, thus reflecting participants' verbatim responses. The data was coded and analysed using the Atlas.ti program and subsequently interpreted. This resulted in themes (reported in Table 2) being identified that enabled proper alignment to findings. Detailed findings are reported in accordance with the themes shown in Table 2.

Table 2: Themes emerging from the data obtained during the interviews

<table>
<tr><th colspan="3">Themes</th></tr>
<tr><th>Perceptions</th><th>Expectations</th><th>Challenges</th></tr>
<tr><th>Sub-themes</th><th>Sub-themes</th><th>Sub-themes</th></tr>
<tr><td>• General perceptions (how internal audit is perceived)
• CAE perceptions
• CFO perceptions (experienced through working with the IAF)
• CAC perceptions (experienced through working with the IAF)</td><td>• IA business partner to management
• Supports audit committee and management
• Independence
• Playing a role in emerging risks
• IA skills set meeting expectations on emerging risks
• Providing insights into strategic initiatives
• IAF functioning at the level of a strategic advisor</td><td>• Performance auditing
• Uniform methodologies/ systems
• Repeat findings
• Business insight
• Combined assurance
• External quality review (QAR)</td></tr>
</table>

(2) Perceptions of IAFs by the participants

Participants were requested to share their perceptions of their SOE's IAF. This question was raised with the intention that it would provide information on how internal audit was seen in the organisation in relation to value-adding, advice and partnering with business for continuous improvements towards achieving strategic objectives.

General perceptions about internal audit

The CAE participants from the three SOEs believed that their IAFs are taken seriously in their organisations, are seen as advisors and are respected. This perception is illustrated in the following quotations:

Internal audit here is seen as an advisor. [A]s much as we are also [an] assurance provider we are [a] key stakeholder in strategic initiatives.

Whatever client, need[s] business survival [advice] they call us. Audit here is well respected, clients call us and we help where we can when resources are available.

I think we have the new board and [it] is very focused … on governance, and the IA [function] is taken more seriously. In the past we were not taken seriously.

The CAC participants perceived internal audit to be serving a critical function within their SOEs, as CACs rely on internal audit to highlight new risks, and to inform the audit committee proactively. There is consensus that internal audit is highly regarded, as reflected in the following quotations:

Internal audit in SOEs play[s] a critical function as they ensure that there are governance process[es] and that the enterprise is accountable in ensuring service delivery.

The audit committee sees internal audit as a critical function in the business, as they rely more on internal audit to highlight and inform the audit committee about issues proactively.

As can be seen from the above quotations, the CAC participants are generally satisfied with the IAFs. However, one of the CAC participants commented that the effectiveness of internal audit also depends on the effectiveness of the audit committee, as the committee is expected to provide leadership and direction to the IAF.

The CFO participants perceived internal audit as supportive, assisting management to implement strategies and achieve objectives. The following quotations convey this perception:

Internal audit is perceived as a very critical stake-holder in the organisation.

I think the value that internal audit brings is that [it] is very important that internal audit find the support. They are a critical business partner.

From the above quotations it can be seen that there is general satisfaction with internal audit by this category of participants, and that internal audit is seen as a positive and critical asset for the business.

(3) Expectations of IAFs by the participants

There is the expectation that internal auditors need to give a forward looking business perspective to top management and the board, proactively pointing out exposures that may arise from future threats (Msiza 2011:28). To do this effectively, they have to understand the business environment in which their organisations operate.

IA as business partner to management

The CAE participants agreed that their IAFs partner with business in order to achieve continuous improvements in their SOEs. The following quotations illustrate their opinions:

That's how we want our clients to perceive us: we are here to partner with you, [and] as much as we have to remain independent … we are partnering with [you] in making sure that you improve.

But in this case the business is welcoming internal audit in their operations, which is becoming a problem. They want them to be involved upfront so that they are assured at inception [that] their processes [are appropriate], rather than waiting for them at completion, to be able to give an opinion whether the internal controls are intact.

These quotations clearly illustrate two respondents' views, that internal audit should partner with management for continuous improvements. The other participant, from the non-strategic sector of the economy, felt that internal audit should not partner with business as it would compromise their independence. This contradiction could be ascribed to the fact that the risk and IAFs of that particular SOE are managed by the same person, whose background is mainly in risk management, suggesting that his awareness of the wider scope of internal audit is still limited. This finding could also point to an area for future research, which could investigate the state of cooperation between IAFs and risk functions in SOEs.

A CAC respondent agreed that there is a need for internal audit to partner with business for continuous improvement. He asserted:

The head of internal audit should build relations with everyone in the business so that the auditee see[s] the internal audit [function] as an advisor so that there is [a] trust element.

All three CFO respondents agreed, and supported the notion that internal audit should partner with business for continuous improvement, as can be seen from the following quotations:

They need to be business partners in terms of validating the management assertions and whatever initiatives which management put[s] in place with regard to the development of the strategy, because if those assertions are not validated we can end up spending the money on things which are not critical to the [required] outcomes.

Another CFO participant asserted:

IA is part of the strategic process. They also participate in [determining] what should be our priorities. And for an auditor to audit they must first understand the environment; in fact they must understand it at the level of the expert so that they will be able to issue sound findings and sound advice. What it does, it makes the IAF that area [of the business] that have the mastering [(understanding)] of the entire value chain of the whole organisation.

A CAC participant agreed:

Internal audit should be knowledgeable about the business because if you are not knowledgeable about the business you go and audit admin issues and lose a bigger picture of organisational strategy. You need business insight, the knowledge of what … you advising on.

Audit Committee and management support

From the above analysis of the views of participants it is clear that IAFs in the three SOEs are supported by both management and their audit committees: they have the resources to meet their mandates, and management support is demonstrated in that IA's recommended corrective actions are implemented.

A CAE participant explained:

I don't think there is anyone who can say they have enough budget … [even though] the media say [my SOE] has the biggest internal audit in the world. If you have a budget you can do more, but I am not complaining [about] the budget that I have: [it] is sufficient to cover [the] amount of work because even the [private sector] firms have limited resources in terms of people. We [manage to] cover strategic audit, high risk areas, so I am comfortable with the budget that I have.

A CAC participant of another SOE agreed with the above notion:

The audit committee will take a key [recommendation] from internal audit in terms of resource requirements, and does ensure that internal audit is fully resourced. As it happened with internal audit of [my SOE], when a request was put forward for specialists within internal audit, the audit committee supported the motivation for the specialists' resources.

A CFO participant largely concurred with the above mentioned views, albeit with some reservations:

I think there is support from management in terms of the budget allocation. … [Internal Audit] can never have enough resources to address the risks of the company, it's a dilemma but with[out] adequate support [it is not possible] to address the medium and low risks of the organisation. The appetite is there from management and the board but it can never be enough.

IAFs in these SOEs are seen as important; they are therefore not the first ports of call when it comes to organisational cost-cutting.

Independence

The backbone of the internal audit profession is the union of auditor independence and objectivity (Stewart & Subramanian 2010:328), which gives rise to value and credibility in the profession, and is manifest as independence of thought and action. The IIA's Standard 1100 for the professional practice of internal auditing requires, that the internal audit activity be independent, and that this independence requires that the chief audit executive reports to a level within the organisation that allows the internal audit activity to fulfil its responsibilities.

From the analysis of the views of participants in the three seniority categories, it becomes clear that the IAFs in the selected SOEs comply with the IIA's Standards relating to independence and objectivity.

A CAE participant reported:

I report directly to the chairperson of the audit committee. Actually the CEO doesn't even want [to] review my reports.

As another CAE participant explained: *Internal audit reports to the audit committee and that's what sits in their charter. Internal audit has direct access [to] the chairperson of the board, external auditors, and audit committee chairperson*.

A CAC participant perceived the IAF to be in *"a powerful position within the organisation"*. He/she therefore believed:

It is imperative that CAEs are pitched at an executive level within the organisation. Internal audit should be the ears and eyes of the audit committee, and must function like the executive of the audit committee.…[They] should not be afraid to raise issues with the audit committee: that is the reason why the head of internal audit has to be able to meet separately with the chair of audit committee.

A CFO participant shared his/her perceptions:

I think our internal audit [function] is independent in terms of structure. [The] reporting line of the chief audit executive is directly to the chairperson of the audit committee. Actually, there is really no interference from the group chief executive, none at all. She/he reports directly to the chairman.

Another CFO participant explained his/her SOE's unique reporting lines that also strengthen the IAF's independence:

We had discussions about the level of independence of internal audit and took a decision that because we are unique from other state entities (we have executive chairman and deputy executive chairman of the board), then for administration purposes, … [the] IAF will be taken away from the chief operating officer. … [W]e will go to the deputy chairman of the board (to make sure that the independence is strengthened), and functionally they report to the audit committee.

From the above quotations the participants highlighted that the IAF has a functional reporting line directly to the to the audit committee.

Playing a role in identifying and managing emerging risks

The literature suggests that internal audit should play a prominent role in risk management (Cavaleros 2013:21; Deloitte 2012:3; Goodwin 2004:648). From the analysis of the views of participants, it becomes clear that the participants believe that internal audit should play a role in managing emerging risks.

A CAE participant explained the conduct of her/his IAF in relation to emerging risks:

We have a risk management committee [meeting] at [my SOE office] every month where we discuss key risks and emerging risks and so on, and we use that to update our audit plan and our consulting plans. So, we play … very significant roles especially on emerging risks. We invest enough time to discuss particular emerging risks and say what our response is on this one.

A CAC participant supported the notion that internal audit has a role to play in managing emerging risks, and explained by providing examples:

There are different forms of SOEs and [they are] classified in terms of schedule 2, or 3a or 3b, [of the Constitution], and some are geared towards the strategic sector of the economy … [and positioned a long way along the] continuum towards commercialisation, and are self-funding. These SOEs compete on the same footing as the private sector. As they expand into other areas like taking over another SOE in the same sector [as my SOE is doing], brought about huge risks which might have affect[ed] [my SOE's] balance sheet. These require that internal audit play a proactive role in identifying these risks. Similarly with the water crisis that happened in Gauteng, internal audit should be highlighting the emerging risk.

Another CAC participant shared his/her expectation regarding combined assurance, but acknowledged that it has not been fully met:

IA can work closely with other assurance providers so that there is combined assurance. We are not yet there, but I think IA should play a critical role and identify the emerging risks.

A CFO participant highlighted his/her expectation as follows:

We expect them [IA] to participate in the risk identification process for the whole organisation. If new risks emerge, or in their plan [they] start identifying new trends which will bring new risks [to our attention], … the expectation is that in their reports they will be highlighting those risks to risk management, so that we can respond or even provide corrective measures.

From the above it can be observed that there is support for the idea that internal audit should play a role in managing risks, as they are already doing. However, a contrasting view was raised by a CAE participant from the non-strategic sector SOE, who believed that the role in identifying and managing emerging risks should be played by the risk function and not the IAF. Again, the fact that the risk function and the IAF are managed by the same person in this SOE, and that his/her background is risk management-orientated, could serve as an explanation, as this attitude also applies to emerging risks.

IA skills set

From the literature review it is evident that there is an expectation that internal audit will cultivate skills and leverage specialists to support areas where it does not yet have the breadth and depth of expertise to provide the required insight (Protiviti 2013:1; Tabuena 2012:30).

From an analysis of the views from participants from all three categories, it becomes clear that the in-house IAF has technical specialists within the function, in line with the business requirements. The outsourced IAF has technical skills provided by the service providers as and when the business requires them, whilst the other SOE has chosen to co-sourced the technical skills as and when required.

A CAE participant explained how he/she manages his/her skills requirements:

Actually the meeting that we had before you came in, that project is led by an engineer from KPMG. So, as much as this is an outsourced [service], [in] the model that I am using to manage the consortium, the only difference between an in-house and outsourced function in my approach is that I don't pay their salaries, but I manage them as if they are my people. A junior auditor on the floor - I want to know if they are being trained; I need to know if there is skills plan, clearly documented, to make sure that they are focused on [my SOE] …. Like I say, as much as they are outsourced, I manage them like they are employed here.

A CAC participant shared his/her advice as follows:

What is required of IAF is to attract and retain the specialists with skills, [the people] who understand the technical nature of the core business of the organisation, complemented with business insight.

A CFO participant indicated his/her expectation:

You have already answered, appropriate skills, competencies that are aligned to the organisational requirement even appropriate capabilities even resources and tools. Having infrastructure that can compete with the best practice requirements out there … in order to gain [the] confidence of management and even [the] audit committee, that means we should be recognised by external parties (being both external auditing and the entire [assurance] fraternity...

Providing insight into strategic initiatives

From the analysis of the views expressed by participants in all three seniority categories it was apparent the IAFs of SOEs participate in strategy sessions, mostly through the CAE, as he/she is a member of the executive committee of the SOE. This can be seen in the following quotes.

A CAE participant stated his\her IAF's position:

We have access to minutes to check any strategic decisions that have to be taken, [and] to also define our roles. Like I said, we prefer a proactive approach. Two things: whenever [my SOE] come up with a new strategic objective already, when I come back from that meeting I get a team together which will zoom into that specific issue [to] try and define our role within that initiative.

A CAC participant maintained that:

Internal audit should take its rightful place and participate in the strategy session and offer advice, and must conduct research on strategic initiatives undertaken by the organisation, and be … [already] prepared to offer support as things happen.

A CFO participant expressed a concurring view:

Internal audit is part of the strategic process: they also participate in [determining] what should be our priorities, and for an auditor to audit they must first understand the environment. In fact, they must understand it at the level of the expert so that they will be able to issue sound findings and sound advice.

From the above quotations there is apparently consensus that the IAF should give insight into SOEs' strategic initiatives.

Internal audit functioning at the level of strategic advisor

Analysis of the views of the participants from all three respondent categories show that IAFs of the SOEs in strategic sectors function at a level where they are able to provide insight into strategic initiatives. However, there was consensus amongst the participants representing the SOE from the non-strategic sector that the IAF still needs to employ additional staff who possess consulting and advisory skills, in order to function at such a level.

(4) Challenges experienced by the IAF

IAFs in SOEs experience challenges relating to a lack of skills to conduct performance auditing; the use of different methodologies and auditing systems by outsourced functions; repeat findings; a lack of business knowledge and insight; participation in combined assurance; and non-compliance with quality assurance and improvement programme standards.

Performance auditing

The Auditor General (AG) normally conducts performance audits of those government entities in whose audits they are directly involved, even though these are classified as discretionary audits and are not regulatory. However, for the SOEs in the strategic sector of the economy, the external audit is conducted by external (private sector) audit firms on behalf of the AG. Thus the AG does not conduct performance audits in these SOEs. Although performance audits are conducted on a non-recurring basis (ad hoc), they are important as a management tool that provides information and feedback leading to improvements to the organisation. One CFO participant expressed the view that IAFs in SOEs need to introduce performance auditing, as this would greatly assist in the achievement of strategies and the optimal use of resources. In addition, it would educate the business around achieving operational economy, effectiveness and efficiency. The participant said:

The area that I feel SOE internal auditors can improve is around performance auditing. I think performance auditing needs to be introduced; it needs to be mandatory. It will really greatly assists in the achievement of the strategy and the optimal use of resources.

Uniform audit methodology and management system

The IAF of one of the participating SOEs is outsourced to different external audit firms at different times, but the audit system remains a manual exercise and the files are also kept manually. A participant from this SOE suggested the introduction of an electronic working paper system, with the SOE owning the intellectual property for the total system. This, it was believed, would enable the different audit firms to use one system, that of the SOE, which would thereby standardise audit processes and improve productivity.

He/she explained:

I am in the process of developing an internal audit methodology for [my SOE]: I don't want the firms to come with their methodology.

He/she further stated:

I am also in the process of acquiring [an] audit management system because currently the audits are completely manual files. So, we are going to have [my SOE's] system so that each firm has to come and use the [SOE's] system, so the intellectual property and whatever, is owned by [my SOE].

Repeat findings

A CAE participant expressed concern about the issue of findings that keep arising:

I mean, yesterday I … managed to summarise the three years' worth of audit findings until March 2014, comparing the three years, to say "these were the key functions, findings and all that". And I said to them, "I am opening discussions with management", and they said "why?". I want them to stop and reflect and [to] say, "Why are these issues coming back now? What are the root causes? Is it the people issue, or [a] culture issue, [a] system issue, [a] management issue or process issue?" so that we can come up with solutions, [so] that we will help us remove the recurring issues, you understand.

He/she explained further:

You can see from the previous years that it is similar issues coming up. And I said, "I want us to come up with lasting solutions which forces management… [to] embed whatever changes need to be embedded, so that we focus on strategic issues. Then the operational matters - let's just embed [solutions] and sort out the root causes and move on."

Business insight

The CFO and CAC participants raised a concern that internal auditors lack insight into the business aspect of their organisations.

A CFO participant attributed the IAF's lack of business knowledge in his/her SOE to their limited experience within the organisation:

You need to have sufficient knowledge of the business, and in our case they are all new. So they are all in their first year, and to acquire knowledge of this type of business, the uniqueness, complexity, it takes time. But there is value that you can add as an auditor, as there are basic things that you can question.

From the above quotation it is clear that management is of the view that IAFs in their SOEs do not have sufficient knowledge of the operations of their organisations, nor of the environments in which the SOEs are functioning. Their expectation goes beyond the mere technical knowledge of auditing related matters, and extends to knowledge of the operations of SOEs and their business environments.

Combined assurance

Principle 3.5 of the King III report (IoD 2009:62) introduced combined assurance as a recommended governance practice. The report also recommended that the IAF should take a leading role in the implementation of combined assurance (IoD 2009:96). The IAFs in the SOEs involved in the strategic sectors of the economy have been involved in the implementation of combined assurance in their organisations; however a concern was raised by a CAC participant of the SOE in the non-strategic sector that combined assurance still has to be implemented and that it could prove a challenge for the IAF.

Internal audit can work closely with other assurance providers so that there is combined assurance. We are not yet there, but I think internal audit should play a critical role and identify the emerging risks.

External quality review (QAR)

In terms of the IIA Standard 1300 for the professional practice of internal auditing, the quality assurance improvement programme (IIA 2012:7) obliges the IAF to develop a quality assurance and improvement programme that covers all aspects of the internal audit function, which should include internal and external assessments. The external assessment has to be conducted at least once every five years (IIA 2012:7). One of the CAC participants raised a concern that his/her SOE had not conducted quality assessment in terms of the Standard, as can be seen in the following quote:

I think most organisations have not gone for external quality assurance as per Standard. Even [my SOE], they have just done peer review, and it is a Standard requirement.

5 CONCLUSION

In the literature review the important role played by SOEs in the economy was made clear. Similarly, from the literature review the important role played by the internal audit functions of SOEs is recognised. But, studies of IAFs in SOEs are in short supply. In an attempt to fill this gap, this study aimed to obtain an understanding of the role of IAFs in SOEs by determining the perceptions of, expectations for and challenges experienced by IAFs in today's SOEs.

The research methodology followed was a qualitative one, utilising a case study method. Three SOEs in South Africa were selected, and the views of important role players associated with the internal audit function, namely the CACs, CAEs and CFOs, were solicited.

The findings of the study show that IAFs in SOEs are perceived in a positive light. The IAFs are expected to act as management's business partners, in efforts to achieve continuous improvements. Additionally, they are supported by both management and audit committees: their independence is not negotiable; they are adequately resourced, and they comply with IIA Standards in this regard. The findings further indicate that some IAFs of SOEs play a role in addressing emerging risks, with the in-house functions being augmented with the employment of technical specialists, all of which enable the IAFs to provide insight into the strategic initiatives of their SOEs.

From the above it is clear that the participants place significant reliance on internal audit. However, IAFs in SOEs face specific challenges: there is a lack of performance auditing in SOEs; methodologies and auditing systems used by outsourced functions differ from those used in and preferred by the SOEs; the issue of repeat findings still recurs; the IAFs lack essential business knowledge and insight; combined assurance is in its infancy, and there is a high degree of non-compliance with quality assurance and improvement programme Standards.

Even though these findings should be considered against the limitations of the study reported earlier (particularly using case studies that draw on the views of a very limited number of participants), the findings do provide insight into an essentially unexplored area. Future research directions could also be identified: for example, to determine whether performance auditing is beneficial for SOEs; to examine how SOEs should most effectively coordinate their in-house, outsourced and co-sourced IAFs; to determine how internal auditors should be educated and trained so that they obtain the desired business acumen and insights most effectively; quantify the status of combined assurance within SOEs, and examine the level and effectiveness of cooperation between IAFs and risk functions in SOEs.

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The root causes for local government’s failure to achieve objectives

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ABSTRACT

The achievement of public sector service delivery objectives is crucial to citizens, both individually and collectively. While the public depends on local government organisations to deliver mostly essential services (the key services being water, electricity, sewerage, and roads), public sector audit reports, as well numerous and frequently recurring service delivery protests, suggest that local government is failing to achieve its objectives. This study aims to identify the root causes of municipalities’ failure to efficiently and effectively deliver the services they are mandated to deliver. A literature study (academic overview) and a review of key documents (specific reports on local government performance) were conducted to achieve this research objective. The study identified four main themes (root causes) that underlie municipalities’ failure to achieve objectives. These root causes are: inadequate human resources capacity; shortage of skills; unethical organisational culture, and ineffective (or non-existent) performance management systems. Specific root causes and the underlying causative factors linked to these four main themes were also identified. Two all-embracing root causes appear to be connected with most of the identified specific root causes and their underlying factors. These are a lack (or total absence) of leadership commitment, and a management system that is almost completely devoid of consequences for poor performance and wrong-doing. These two all-embracing root causes were identified as fundamental to the majority of the identified failures.

Key words

Local government organisations; achievement of objectives; root causes for non-achievement

1 INTRODUCTION

Organisations exist in order to achieve specific objectives. The achievement of their objectives and their efforts to increase stakeholders’ value should be the ultimate goal of every organisation, regardless of the sector in which they operate. Thus, those within the three spheres of South African government - national, provincial and local - should also be applying themselves to achieving this ultimate goal. In the context of South African local government, the key objectives are to render efficient and effective delivery of basic services to the public. Local government’s political and administrative leadership is therefore required to ensure that public funds are appropriately utilised to achieve service delivery objectives and targets. However, the claimed achievement of service delivery objectives by local government leadership is being questioned, as evidenced by the increasingly frequent and violent demands expressed by the public (Nengwekhulu 2009:342; Basheka & Mubangizi 2012: 637; Van Baalen, Schutte & Von Leipzig 2015:3). Local government organisations thus seem to be struggling to achieve these service delivery objectives.

The Auditor General South Africa (AGSA) revealed that during the 2012-13 financial year, 133 (42%) out of their total of 319 audit clients failed to achieve 20% or more of their performance targets (AGSA 2014:40). Despite its high relative number, it is still an improvement over the previous (2011-12) financial year where 169 (53%) out of a total of 317 local government organisations audited did not achieve 20% or more of their performance targets (AGSA 2013a:53). Local government’s failure to achieve its objectives is being brought to the attention of the wider public by the increasing number and violence of service delivery protests currently taking place in the country (PSC 2010:40; Makhado, Masehela & Mokhari 2012:3). And despite the relatively “old” academic references, the inferences drawn from daily media reports are that the problems have continued to escalate.

This study aims to identify the reasons why local government organisations fail to achieve their service delivery objectives. In the next section, the research objective and its contribution to academic research are described, and this is followed by a section describing the methodology, scope and limitations of the study. An overview of the existing literature on the research topic is subsequently highlighted, in which the thematic causes for local government’s failure to achieve its objectives are described. This is followed by the presentation of the research findings, which are based on a review of pertinent documents that highlight root (specific) causes underlying each of the four thematic causes. These are subjected to further analysis to find the underlying factors contributing to these causes. Finally, a conclusion is provided and solutions suggested.

2 RESEARCH OBJECTIVE AND CONTRIBUTION

The objective of the study was to identify the root causes for non-achievement of objectives by South Africa's local government sector. This failure to achieve objectives has been repeatedly reported by the AGSA. There are three key benefits that arise from knowing the root causes for the failure to achieve objectives.

Firstly, International Standards for the Professional Practice of Internal Auditing, Performance Standard 2110, gives internal auditors the mandate to assist organisations to achieve their objectives through providing recommendations which improve the governance process (IIA 2012). Fundamental to succeeding at this task is an understanding of the root causes of the entity's (local government's) failure to achieve its objectives. Once understood, internal auditors are in a better position to advise management on appropriate measures to address these causes. This will enable internal auditors to better fulfil their mandate to assist local government to achieve their objectives.

Secondly, once the root causes for the failure to achieve objectives are known, management can develop appropriate and specific corrective strategies and measures that will enable their statutory and regulatory objectives to be achieved more efficiently and effectively. This should improve the level of service delivery to the public, and positively contribute to the growth of the country's economy.

Thirdly, although the focus of this study is on local government, some of the lessons learned from this research may be applicable to other spheres of government, as well as to private sector organisations, thus helping them all to improve their approaches to achieving their objectives.

3 RESEARCH METHODOLOGY, SCOPE AND LIMITATIONS

The research methodology consisted of a literature review and a document review. A literature review was conducted to synthesise a theoretical framework that would explain the non-achievement of organisational goals. The literature review thus identified the thematic root causes for non-achievement of objectives within local government organisations. Thereafter a review of key documents (the AGSA's annual audit reports) was conducted in order to answer the specific research question as it relates to South African local government – to answer the question "what is wrong?" This was followed by further investigation to discover the fundamental causes (the "why are things this way?") of the failure of local government to deliver on its mandate, and to identify and understand probabilities and trends in this regard.

Guided by the thematic root causes identified during the literature review, a review of key documents was performed to identify specific root causes relating to the thematic causes. The documents chosen for critical review were the AGSA's consolidated general reports on the audit outcomes of local government organisations for the financial years 2011-12, 2012-13 and 2013-14, in order to identify specific root causes for the failure to achieve objectives. These reports were selected for review because they are the official documents reporting on the results of external audits done on local government's reporting of failures (and occasional successes) to achieve its objectives.

The scope of this study covered the AGSA's consolidated general reports for the financial years 2011-12, 2012-13 and 2013-14. The total number of local government organisations audited by the AGSA was 317 for the 2011-12 financial year (AGSA 2013a:24), 319 for the 2012-13 financial year (AGSA 2014:40) and 325 for the 2013-14 financial year (AGSA 2015:4).

4 LITERATURE REVIEW

The literature was reviewed in order to identify thematic root causes for non-achievement of objectives by local government. The review of the literature revealed the following four themes as the recurring root causes and thus the main impediments to the efficient and effective achievement of objectives within government organisations:

- Human resource capacity that is inadequate, and thus unable to ensure efficient and effective achievement of objectives (National Treasury 2007:2; Nengwekhulu 2009:346; COGTA 2009: 4; PSC 2011:16; Deloitte 2012:3; Municipal Demarcation Board 2012:15; National Treasury 2012:6; Draai & Oshoniyi 2013:869; Van Baalen *et al*. 2015:3);
- Shortage of skills required to execute functions efficiently and effectively (Kanyane 2006:116; PSC 2008:34; COGTA 2009:22, 66; Koma 2010:116; SALGA 2011; Deloitte 2012:3; Sing 2012:383; Draai & Oshoniyi 2013:870-871, 868; Van Baalen *et al* 2015:5);
- Unethical organisational culture that condones the use of government resources for personal gain (COGTA 2009:10, 54-55; Nengwekhulu 2009:356; Deloitte 2012:1, 3; Makhado *et al* 2012:3; PSC 2010:13; PSC 2011:13-14; Basheka & Mubangizi 2012:637; Masiloane & Dintwe 2014:186; Van Baalen *et al* 2015:4); and
- Ineffective performance management systems that fail to provide management with timeous warnings of non-achievement of objectives, and thus inhibiting the implementation of corrective actions (Nengwekhulu 2009:356; Biron, Farndale & Paauwe 2011:1306; Deloitte 2012:3; Baird, Schoch & Chen 2012:165, 175).

While it is recognised that these are not the only causes for local government's failure to achieve its objectives, based on the literature review they appear to be the most common and pervasive causes. These four causes are discussed briefly below.

4.1 Inadequate human resources capacity

The local government sector depends mainly on human capital in order to achieve its objectives (PSC, 2011:16; Van Baalen *et al* 2015:4). Nevertheless, inadequate human resources capacity has been identified as one of the aspects negatively affecting the performance of local government, and this lack of capacity is due to ongoing high vacancy rates (COGTA 2009:4; Deloitte 2012:3; Van Baalen *et al* 2015:3). The Municipal Demarcation Board (2012:15) highlighted that as at end of 2011 financial year, an average of 32.5% of the funded posts within the local government sector nationally were vacant. An aggravated concern is that some of these vacancies are for key positions such as municipal managers and chief financial officers. The National Treasury (2012:6) reported that as at 02 October 2012, 20.9% of municipalities were headed by acting municipal managers, while for acting chief financial officers the statistic was 25.9%. It should be fairly obvious that these vacancies in key positions, and the excessive time taken to fill them, negatively affect the productivity and efficiency of local government entities (Deloitte 2012:3; Draai & Oshoniyi 2013:869).

The high staff turnover which occurs as a result of frequent changes in leadership, and particularly after each election, exacerbates the challenge of inadequate human resources within the local government sphere (COGTA 2009:66). The same phenomenon of high staff turnover was also highlighted by the Municipal Demarcation Board. In a report cited by the National Treasury (2012:7) it was noted that for municipal managers nationally, the average tenure was 3.34 years, while for municipal chief financial officers the average was 3.78 years. This instability in the leadership has a negative impact on local government's ability to achieve its objectives (National Treasury 2012:5).

Inefficient utilisation of available resources has also been identified as one of the challenges facing the public sector (National Treasury 2007:2). For example, the manner in which positions are created in the public sector does not seem to contribute to the efficient utilisation of the resources needed to enhance the rate of achievement of objectives. The positions are reportedly created on the basis of "logical sequence", and not necessarily on the job's demands or complexity (Nengwekhulu 2009:346). For instance, it is the norm within the local government employment hierarchy that the position below that of the Municipal Manager is that of a Director, and so forth. No assessment is performed to determine whether the job of the Director could actually be done by the person at the Manager level, which would then result in resource savings. This suggests that public funds are being used to maintain a bureaucratic hierarchy, rather than being utilised for funding personnel who are appropriately skilled for the achievement of project-specific service delivery objectives.

4.2 Shortage of skills

Employees' skillsets are a valuable asset, essential for the organisation's success (Robbins 2008:126; Baird *et al* 2012:175), and it takes qualified and skilled employees to execute their individual functions efficiently and effectively in order to ensure the achievement of the organisation's objectives. The shortage of skills has been identified as one of the highest contributors to the failure of the local government sector to deliver services to the public (Kanyane 2006:116; COGTA 2009:22; Deloitte 2012:3). Both technical and administrative skills are required in order for the local government sector to improve its service delivery performance (Koma 2010:116; Draai & Oshoniyi 2013:868).

The Local Government Sector Education and Training Authority, as cited by Koma (2010:115), reported that 31% of municipal managers did not have appropriate qualifications in the areas of finance, law, public administration, planning or development, while only 28% of chief financial officers did have finance related qualifications. The report further indicated that 35% of technical managers did not have engineering qualifications. The study by Van Baalen *et al* (2015:5) also confirmed that technical managers do not have the qualifications and/or experience required to ensure efficient and effective achievement of municipal objectives. This state of affairs (under-skilled and/or inappropriately skilled personnel) within local government has a negative impact on the performance of the local government. In an attempt to address the problem of skills shortages, the government introduced the Joint Initiative on Priority Skills (JIPSA) in 2006. The JIPSA outlines, amongst others, strategies that the government intended to apply to resolve the shortage of skills (Draai & Oshoniyi 2013:871). That the problems in the public sector appear at least as severe as they did a decade ago underlines the pervasive nature of the skills shortage, as it has apparently also affected the initiative established to remedy it.

One of the reasons identified as a contributing factor to the skills shortages is the fact that senior local government appointments seem to be based on whether the appointees support the political direction of the government or ruling party, and not necessarily on their qualifications, skills and experience (Kanyane 2006:116; SALGA 2011; Deloitte 2012:3; Mashumi 2013:632). There seem to be politically motivated interferences in the recruitment processes of the local government sphere, manifesting as a disregard for the candidate's technical competence (COGTA 2009:66). In addition, the government in general is faced with a problem of accelerated staff mobility where, after just one year in a position an employee is promoted to a higher position. Such employees are therefore not provided with an opportunity to deepen and broaden their skills in anticipation of later promotion to higher positions (Sing 2012:383). This ultimately results in the managerial field being one of the areas in the local government where there is a significant skills shortage (Draai & Oshoniyi 2013:870).

The other aspect contributing to the skills shortage within local government is the lack of skills development programmes and of commitment to training (COGTA 2009:66; Mashumi 2013:635). Deloitte (2012:3) has further identified that there is a dearth of regular training and development programmes on offer for local government employees, and this is contributing to the failure to achieve objectives efficiently and effectively. The PSC (2008:34) revealed that 31% of surveyed leaders within the public service had not identified the technical training needs of the personnel in their development plans. This implies that on-going training and development to enhance efficiency and effectiveness of staff in the execution of their duties is considered a low priority.

4.3 Unethical organisational culture

Robbins and Judge (2013:559) define ethical organisational culture as a culture which shapes high ethical standards among its members, takes into consideration the rights of various stakeholders, and is not only concerned with what goals are achieved but also how such goals are achieved. Unethical business practices in both the financial and performance areas have been identified as key factors contributing to the poor performance of local government (COGTA 2009:55; Deloitte 2012:1; Van Baalen *et al* 2015:4). Various studies acknowledge that the government has sufficient guidelines, legislation and regulations in place to operate ethically, efficiently and effectively, if motivated to do so, and that the unethical behaviour is mainly attributed to non-compliance with such laws and regulations (COGTA 2009:54; PSC 2010:13; Deloitte 2012:1).

The PSC (2011) study identified various business practices within local government that do not promote the creation of an ethical environment. Firstly, it was noted that the recruitment and/or selection committees of some municipalities did not have a formal process requiring members to declare potential conflicts of interests. This therefore created an opportunity for favouritism and nepotism to influence appointments (PSC 2011:13). Secondly, the study further highlighted that some municipalities did not have a security vetting process for key positions such as chief financial officers and supply chain managers. Such a process usually includes criminal and credit checks, verification of qualifications and reference checking (PSC 2011:14). The absence of this security vetting process puts the municipalities at heightened risk of appointing potentially unethical applicants who may be involved in fraudulent and corrupt activities.

Basheka and Mubangizi (2012:637) highlighted the fact that the rate of incidents of fraud and corruption within local government in South Africa appears to be increasing. The absence of adequate internal controls within the financial management systems of the local government functions certainly contributes to increasing this rate of fraud and corruption (COGTA 2009:54). Notwithstanding the fact that the research conducted by Masiloane and Dintwe (2014:186) focused on the public sector as a whole, they also confirmed that the rate of occurrences of fraud and corruption is constantly increasing. The corollary is that increasing amounts of public funds are being consumed by incidents of fraud and corruption, and in pursuing the perpetrators. This increase obviously compromises the achievement of objectives by local government, as the public's funds are being illegally diverted away from their intended use to further the perpetrators' personal gain (COGTA 2009:10; Deloitte 2010:1).

COGTA (2009:55) and Nengwekhulu (2009:356) identified the lack of accountability and the absence of an effective disciplinary system within the public service as two of the factors contributing to its failure to perform. There appear to be no visible consequences for failure to perform or achieve objectives (Deloitte 2012:3), leaving public servants in general with no strong evidence that poor performance cannot be accepted or tolerated. The absence of consequences for unethical behaviour and poor performance also seems to be contributing to senior managers' lack of commitment to improve compliance and performance. This theme is present in the findings of the study conducted by Afesis Corplan, in partnership with the Department of Traditional and Local Government (Basheka & Mubangizi 2012:645). The study showed that 40% of respondents (members of the public) indicated that they had lost faith in municipalities and that it was pointless to report corruption cases since nothing would be done to address the issues (Basheka & Mubangizi 2012:645).

4.4 Lack of effective performance management systems

Deloitte (2012:3) found that the failure to achieve objectives by the local government can be attributed to ineffective or absent performance management and monitoring processes. This is despite the fact that government has put in place a performance management system. Baird *et al* (2012:175) found that ineffective performance management systems are a general business problem, and not only a challenge to the South African public service. The study by Biron *et al* (2011:1306) highlighted that high-performing organisations had their performance management systems actively led by senior managers, and that it was not merely seen as a process to be managed by Human Resources and/or incorporated into line managers' processes. The key advantage of having senior managers take the lead is that the performance management system becomes fully aligned with the organisation's strategy (Biron *et al*. 2011:1306), thereby positioning the organisation to achieve its strategic objectives more effectively and efficiently.

In light of the above, Nengwekhulu (2009:356) found that the apparent absence of a positive correlation between performance bonuses paid and the performance being rewarded, is not surprising. That this results in non-performers being rewarded as well as performers is equally unsurprising. This results in the demoralisation of the best performers, as good performance and non-performance are equally rewarded (Nengwekhulu 2009:356). Various authors cited by Baird *et al* (2012:165) emphasise the importance of linking the performance with the rewards. This linking motivates superior performers to continue excelling, while at the same time encouraging poor performers to improve their performance (Baird *et al* 2012:165).

4.5 Conclusion

The literature review revealed that local government does not have adequate human resources (sufficient numbers), nor the skills required to ensure efficient and effective achievement of municipal objectives. In addition, not enough appears to be being done by the leadership to create an ethical organisational culture, and performance is unlikely to improve until an effective performance management system is put in place and becomes fully functional. The next section explores these four thematic root causes further to identify each one's own underlying and specific root causes, as manifest in South Africa's public service organisations.

5 FINDINGS

5.1 Results of the review of key documents

The AGSA's consolidated general reports on the audit outcomes of local government for the 2011-12, 2012-13 and 2013-14 financial years were reviewed in order to identify the root causes of each of the thematic root causes of non-achievement of municipal objectives identified in the literature review.

5.1.1 Inadequate human resources capacity

The AGSA expressed concern regarding the inadequate management of vacancies within local government. The report revealed that there were vacancies in the key senior positions of municipal managers, chief financial officers and heads of supply chain management units (AGSA 2013a:107; AGSA 2014:58; AGSA 2015:77-79). The details are summarised in Table 1 below.

Table 1: Vacant positions for senior managers (own compiled table)

Position	Vacant positions as at year-end			Movement description
	2011-12	2012-13	2013-14	
Municipal Managers	21%	16%	12%	The rate decreased by 5 percentage points (or 23.8%) in 2012-13 and by further 4 percentage points in 2013-14
Chief Financial Officers	23%	27%	13%	The rate increased by 4 percentage points (or 17.4%) in 2012-13 but decreased by 14 percentage points in 2013-14
Heads of Supply Chain Management units	21%	31%	24%	The rate increased by 10 percentage points in 2012-13 but decreased by 7 percentage points in 2013-14

The above results indicate that while the vacancy rates fluctuate for all three of these key managerial positions, there is no material improvement in the situations in the longer term.

In addition, the reports indicate a high staff turnover rate amongst municipal managers, chief executive officers, chief financial officers and heads of supply chain management units. The incumbents occupied these positions for an average period of just less than two years (AGSA 2014:58). This high turnover rate also plays a part in increasing the vacancy rate of these positions – and complying with statutory recruiting procedures adds many months to the turn-around time. Operating at a high vacancy rate may also have a negative impact on the efficient and effective achievement of municipal objectives, as some objectives (tasks/projects) may not have dedicated officials managing them. In addition, vacancies inevitably increase the workloads of the remaining staff, a situation that usually accelerates staff turnover and skills loss due to these often extended periods of excessive workloads.

5.1.2 Shortage of skills

The shortage of skills was substantiated by the number of officials who occupied key senior positions, despite not being in possession of the required minimum qualifications and competencies for their posts. The AGSA's 2011-12 report indicated that 73 (35%) municipal managers, 67 (33%) chief financial officers and 73 (36%) heads of supply chain management units did not meet the minimum competency levels required by municipal regulations (AGSA 2013a:110). Similarly, for the 2013-14 financial year, 52 (19%) municipal managers, 60 (22%) chief financial officers and 57 (26%) heads of supply chain management units did not meet the minimum competency levels required by municipal regulations (AGSA 2015:80), and in 2014 the AGSA (2014:60) found that senior managers employed by 134 (42%) of its audit clients, and that finance officials at 145 (45%) of its audit clients also did not possess the minimum competencies and skills prescribed by municipal regulations for the 2012-13 financial year. This implies that these key officials may not be able to execute their functions to acceptable (required) levels of efficiency and effectiveness because they lack the competencies and skills these positions require (AGSA 2013a:113). The local government organisations and functions may consequently fail to achieve any of their intended service delivery objectives.

The AGSA's reports also identified the number of senior managers who had been appointed but who did not have the prescribed qualifications for these positions (AGSA 2013a:111; AGSA 2014:60). The details are summarised in Table 2 below.

These results indicate that there was a significant increase in the number of executive management members in 2012-13 as compared to 2011-12, who were appointed despite not being in possession of the required qualifications. It therefore appears that not enough is being done by the national and provincial leadership to support local governments' efforts to deal with the current shortage of skills. Instead, consultants are increasingly being appointed to perform the functions which should have been executed internally by the government employees (AGSA 2013b:6). Employing consultants results in significant additional expenditure.

Table 2: Senior managers appointed without minimum qualifications (own compiled table)

Position	Number of senior managers appointed without being in possession of prescribed qualifications		Increase percentage
	2011-12	2012-13	
Municipal Managers	10	30	300%
Chief Financial Officers	19	32	168%
Heads Supply Chain Management units	16	39	244%

The lack of leadership commitment to address these skills shortages was further substantiated by the fact that although consultants were extensively used by municipalities, there was no apparent transfer of skills at 139 (47%) of the 2013-14 audit clients, at 155 (62%) of the 2012-13 audit clients, and at 138 (61%) of the 2011-12 audit clients where the AGSA performed an audit of management of consultants. Recurring assistance from consultants and an increase in the overall usage of consultants by local government could be indicative of an absence of skills transfer (AGSA 2013a:114; AGSA 2014:62; AGSA 2015:84).

In support of this contention, during the 2011-12 financial year the AGSA (2013:116) reported that the recurring utilisation of consultants has occurred at 199 (88%) of its audit clients. Furthermore, for 2012-13 financial year 130 (52%), and for 2013-14 132 (45%) of the AGSA's audit clients did not monitor or manage the performance of consultants, thus failing to ensure that they were working efficiently and effectively to achieve the municipal objectives (AGSA 2014:62; AGSA 2015:84). While not specifically stated, this lack of interaction creates an impression that consultants were employed to "do the work" and not to address the skills gap, even as a useful by-product. In addition, failure to manage and monitor consultants' performance increases the possibility that local government is paying for inferior quality services, rendered by consultants that may not be fully familiar with local governments' statutory and regulatory environment, thus resulting in further fruitless expenditure.

5.1.3 Unethical organisational culture

The AGSA reported that of local government organisations audited, there were material findings related to non-compliance with laws and regulations for 94% of clients for 2011-12, 90% for 2012-13 and 79% for 2013-14 (AGSA 2013a:58; AGSA 2014:42; AGSA 2015:9). This high rate of non-compliance may suggest that the government is not endeavouring to establish an ethical foundation to the official activities of government organisations.

The AGSA's report revealed two phenomena which appear to explain this high rate of non-compliance with laws and regulations. The first phenomenon (root cause) is the almost total absence of effective or significant basic internal controls intended to prevent unethical behaviour and to address failures to achieve objectives effectively (AGSA 2013a:94; AGSA 2014: 19). This breakdown of controls resulted in the following:

- **Irregular** expenditure totalling R11.4 billion was accumulated by 264 (81%) municipalities for the 2013-14 financial year; the comparable figures were R11.6 billion accumulated by 265 (83%) municipalities for the 2012-13 and R9.8 billion accumulated by 266 (84%) of the municipalities for 2011-12 (AGSA, 2013a:80; AGSA, 2014:46; AGSA 2015:48). This represents an increase of 24% for the 2012-13 financial year as compared to the previous year and a slight decrease of 6% in 2013-14 (AGSA 2014:26; AGSA 2015:48). As irregular expenditure constitutes amounts that were spent in contravention of legislation and outside of approved programmes (AGSA 2013a: 79; AGSA 2014:47; AGSA 2015:48), the sustained high values recorded above support the notion that not much is being done to promote an ethical culture within municipalities. This environment enables government resources to be utilised for personal gain instead of for the achievement of service delivery objectives.
- An accumulated **unauthorised** expenditure of R11.4 billion was incurred by 190 (71%) municipalities during the 2013-14 financial year, compared with R9.2 billion incurred by 170 (53%) municipalities during the 2012-13 and R9.8 billion incurred by 181 (57%) municipalities during the 2011-12 financial year. Unauthorised expenditure represents amounts that were spent on unplanned, unapproved and unbudgeted activities and objectives (AGSA 2013a:77; AGSA 2014:45; AGSA 2015:51). Over time, this can contribute to the failure of local government, as increasing numbers of objectives are compromised, increasing the possibility that the municipality is judged to be no longer a going concern.
- **Fruitless and wasteful** expenditure of R687 million was accumulated by 250 (77%) municipalities during the 2013-14 financial year, in comparison with the total of R815 million accumulated by 220 (69%) municipalities during the 2012-13 financial year, and R568 million accumulated by 202 (64%) municipalities during the 2011-12 financial year. The 2012-13 figure for fruitless and wasteful expenditure thus represents an increase of 31% over the previous year, while the 2013-14 figure shows a slight decrease (AGSA 2013a:83; AGSA 2014:26; AGSA 2015: 50). Fruitless and wasteful expenditure relates to the amount spent incorrectly or inappropriately, and which could have been avoided if reasonable care had been taken (AGSA 2013a:82; AGSA 2014:49). Again, this expenditure represents money that could have been utilised in pursuit of

authorised and legitimate service delivery objectives.

The AGSA (2014:45) expressed its concern regarding municipal managers who had not instituted the measures necessary to prevent irregular, unauthorized, and fruitless and wasteful expenditures.

The second root cause identified as contributing to the increasing rate of non-compliance is the apparent lack of consequences for transgressions of regulations and laws, and for poor performance (AGSA 2013a:103; AGSA 2014:19). The AGSA (2013a:92; 2014:25; AGSA 2015:10) revealed that this lack of consequences was evident in about 71% of audit clients during both the 2011-12 and 2012-13 financial year audits and in 42% of audit clients during the 2013-14 financial year. The report further highlighted that some audit clients had not yet investigated the previous year's irregular, unauthorised, and fruitless and wasteful expenditures, and had failed to determine if any person was liable, or could be held responsible, for the purpose of recovering such money, as is required by the Municipal Finance Management Act (South Africa 2003; AGSA 2013a:103; AGSA 2014:45; AGSA 2015:10). When public servants are not held accountable for non-compliance with laws and regulations and poor performance, the perception is created that such behaviour is acceptable and tolerated (AGSA 2013a:92; AGSA 2014:80).

5.1.4 Lack of effective performance management systems

The AGSA reported on local government's performance at an organisational level and at an individual level. These two levels are discussed below.

Performance at an organisational level

The AGSA's reports indicate that 61% of audit clients for 2013-14, 66% for 2012-13 and 74% for 2011-12 had material findings pertaining to the quality of annual performance reports, which illustrates the extent to which objectives have been achieved (AGSA 2013a:51; AGSA 2014:40; AGSA 2015:11). This is despite the development and promulgation of various pieces of legislation on performance information that also provide guidance on strategic planning, performance management and reporting. In addition, the AGSA (AGSA 2015:69) reported that 47% (152) of its audit clients for 2013-14, 50% (160) for 2012-13 (AGSA 2014:40) and 37% (116) for 2011-12 (AGSA 2013a:51) did not comply with this legislation. Municipalities' non-compliance with performance information legislation has resulted in the following audit findings, which explain why the process of performance management is seen as ineffective:

- The annual performance reports are not aligned with IDPs and Service Delivery Budget Implementation Plans (SDBIPs). IDPs and SDBIPs are documents containing the definitions of service delivery objectives, performance indicators and targets. The annual performance reports prepared by municipalities are required to identify the progress made towards achieving these objectives, performance indicators and targets where these are different from those defined in the IDPs and SDBIPs (AGSA 2013a:55; AGSA 2014:41; AGSA 2015:68). These differences suggest that government resources were utilised to execute unapproved and unplanned activities or service delivery objectives, and may result in the planned and approved service delivery objectives not being achieved.
- The objectives set out in the IDPs and SDBIPs are not specific and measurable, and it is thus difficult to monitor their achievement effectively (AGSA 2013a:55; AGSA 2014:41; AGSA 2015:68). This complicates the process of establishing how well the organisation has performed relative to its objectives. Failure to monitor the performance of the organisation with any degree of accuracy or certainty may ultimately result in under-achievements not being detected, and thus not being corrected in a timely manner.
- Although some local government entities acknowledged that their objectives had not been achieved, no reasons were offered for these failures, and the action plans to improve the performance were also absent from the annual performance reports (AGSA 2013a:55; AGSA 2014:41; AGSA 2015:68). Local governments may therefore experience repeated failure to achieve their planned service delivery objectives because the underlying root causes remain unidentified and unaddressed.
- For audit clients who did manage to prepare annual performance reports, the information contained in these reports was seen by the AGSA as "not useful" and "unreliable" for 145 (45%) of its audit clients for 2012-13 (AGSA 2014:40) and for 131 (56%) of its audit clients for 2011-12 (AGSA 2013a:55). Although there was a decrease from 56% to 45% during 2012-13 financial year, the number of audit clients with annual performance reports which were seen as neither useful nor reliable increased during 2013-14 financial year to 167 (55%) and 158 (52%), respectively (AGSA 2015:68).

Performance at an individual level

The AGSA expressed concern regarding local government's failure to embed principles pertaining to the performance and productivity of employees. The report highlighted that 36 municipal managers did not have signed performance agreements in place for 2011-12, while 37 municipal managers' performance agreements for the same period did not comply with the Municipal Systems Act (MSA). The report also revealed that at 33 (10%) municipalities for 2011-12, at 40 (12%) municipalities for 2012-13 and at 26 (10%) municipalities for 2013-14, their senior managers did not have any performance agreements in place. (AGSA 2013a:105; AGSA 2014:60; AGSA 2015:81). Without a performance agreement in place, municipalities may not be able to adequately monitor whether employees are achieving their objectives or not. This may compromise the achievement of organisational objectives as the organisation's performance is dependent on the sum of the individual employees' performance.

The report further indicated that municipal managers at 85 (41%) of the municipalities audited had not received performance evaluations in the 2011-12 financial year, and that at 53 (21%) of the municipalities *none* of the senior managers had had performance evaluations in the same period. In addition, for the 2011-12 financial year, 41 (20%) municipal managers and senior managers at 37 (14%) municipalities had been paid performance bonuses without having participated in performance evaluations, and these bonuses had not been approved by their municipal councils (AGSA 2013a: 105). In addition, for the 2012-13 financial year 43 (13%) municipalities still did not have performance management systems in place for employees other than senior managers (AGSA 2014:60). The implication is that local governments might have paid performance bonuses to numerous employees who had failed to achieve their performance targets.

The results of the documentary review have highlighted specific root causes linked to each thematic root cause identified in the literature review. These specific root causes were subjected to further analysis in order to identify the factors and reasons which contribute to and underlie these specific root causes, as well as to identify any potential trends in this regard. The results of this analysis are outlined in the next section.

5.2 Analysis of the factors underlying and contributing to specific root causes

Table 3 below presents each thematic root cause (generic) identified in the literature review, and under each of these are the specific root causes identified during the documentary review (AGSA reports). These specific root causes are then linked to the underlying causative/contributing factors.

Table 3: Linking thematic root causes to specific root causes and their underlying causative factors

Summary of specific root causes identified during the documentary review	Underlying factors contributing towards the existence of specific root causes
Thematic Root Cause 1: Inadequate human resources	
Municipalities have high vacancy rates for their senior positions.	• Some vacant senior positions take in excess of six months from becoming vacant to be advertised (AGSA 2013a:108). Certain senior positions remained vacant for more than six months (AGSA 2014:58; AGSA 2015:76), and others were still vacant more than twelve months after becoming vacant (AGSA 2013a:107; AGSA 2015:77). • There are no formalised and streamlined recruitment, selection and appointment processes to speed up the filling of vacant positions (AGSA 2013a:109). • Some municipalities have unprofessional, politicised images, and their remoteness and poor working conditions prevent them from attracting the professionals needed to effect a turnaround in local government administration (AGSA 2013a:109).
High staff turnover at municipal manager, chief executive officer, chief financial officer and head of supply chain management unit level.	• The absence of standardised salary scales enable municipalities to poach staff from each other by offering higher remuneration packages (AGSA 2013a:109). • There appear to be regular administration leadership changes or restructurings within municipalities that are politically driven, especially after elections.
Thematic Root Cause 2: Shortage of skills	
Some officials in key senior positions do not meet the minimum competency levels required by municipal regulations, while others do not have the required formal qualifications.	• Technical knowledge of financial and performance management and reporting is not a prerequisite for elected officer-bearers (AGSA 2013a:90). • Current employees are not required to attend regular training and development courses, and they are thus failing to keep up with changes in the local government environment and improvements in their specific fields of expertise (AGSA 2013a:110).
At a majority of municipalities there is no transfer of skills from consultants to the in-house employees, which results in the recurring utilisation of consultants.	• Some contracts entered into with consultants do not include the transfer of skills as a deliverable (AGSA 2013a:118; AGSA 2015:86). • In some instances where skills transfer is included as a deliverable in the consultants' contracts, there are no monitoring measures in place to ensure compliance (AGSA 2013a:118; AGSA 2015:86).
Thematic Root Cause 3: Unethical Organisational Culture	
Over 90% of audit clients did not comply with performance-specific laws and regulations in either of the financial years under review. In addition, there was a high rate of irregular, unauthorized, and fruitless and wasteful expenditure within local government organisations.	• There appear to be no consequences for transgressions of and non-compliance with statutes and regulations, as evidenced by the approximately 71% of audit clients identified annually as delinquent in these areas (AGSA 2013a:92; AGSA 2014:25). • The local government leadership appears to be unable or unwilling to set an appropriate "tone at the top" that would indicate that transgressions will not be tolerated (AGSA 2013a:104). When public servants are not held accountable for failing to comply with

Summary of specific root causes identified during the documentary review	Underlying factors contributing towards the existence of specific root causes
	laws and regulations, and poor performance goes unchallenged, the perception created is that such behaviour is acceptable and/or tolerated (AGSA 2013a:92; AGSA 2014:80). • There appear to be no basic controls in place to prevent irregular, unauthorized, and fruitless and wasteful expenditure from occurring (AGSA 2014:45).
The cases of irregular, unauthorized, and fruitless and wasteful expenditure are not investigated, and reasonable measures are not taken to recover such expenditure where there was negligence on the part of specific employees.	• There appears to be pressure from political leadership to prevent investigations into transgressions, and/or to minimize actions taken against alleged transgressors (AGSA 2013a:104). • There appears to be a lack of commitment by political leadership at all levels, to mitigate the current weaknesses in systems and regulations that are responsible for inhibiting the efficient and effective delivery of services to the public (AGSA 2013a:112).
Thematic Root Cause 4: Lack of effective performance management system	
The majority of municipalities had material findings published relating to the quality of their performance reports. These findings include views that: • The performance reporting was not in line with the planned and set service delivery objectives, and did not respond appropriately to performance indicators and targets. • Objectives set in the IDPs and SDBIPs were not specific and measurable, making it difficult to effectively monitor their achievement. • Reasons for under-achievements were not identified, and the action plans to address them were not documented in the annual performance reports. • Information contained in the annual performance reports of some audit clients was seen as 'not useful' and 'unreliable'.	• Strategic planning, and performance management and reporting is not compliant with legislation (AGSA 2013a:51; AGSA 2014:40; AGSA 2015:69) which also provides guidance on how quality performance reporting can be achieved. • Municipalities are not able to adequately plan, manage and report on their own performances (AGSA 2013a:55). • The AGSA has repeatedly provided recommendations on how the performance information can be managed to ensure efficient and effective achievement of objectives. However, the political leadership seems to be slow to implement these recommendations that would otherwise address the root causes of poor performance (AGSA 2013a:89; AGSA 2014:79). • There appears to be a lack of commitment by the political leadership to rectifying the weaknesses currently preventing efficient and effective delivery of services to the public (AGSA 2013a:112).
Some municipal managers and senior managers either did not have performance agreements in place, or their performance agreements did not comply with the requirements of the MSA.	The culture of improving the performance of municipalities through assigning objectives to specific officials to enhance their achievement and ensure accountability seems to have not yet been entrenched (AGSA 2014:60).
Some municipal managers and senior managers received performance bonuses even though no performance evaluation had been performed.	The mayor and council appear to lack the commitment to ensure that the performance bonuses are paid only to deserving senior managers and municipal managers who have achieved their targets (AGSA 2013a:106), even though this would also encourage those who did not perform well to improve.

The above table summarises the underlying factors contributing towards the existence of the specific root causes that were identified in section 5.1. The analysis revealed two trends that appear to be connected with most of the identified underlying factors, namely a lack of leadership commitment and a lack of consequences for poor performance and non-compliance. Efforts to address these two underlying factors adequately are needed in order to enhance the achievement of municipal objectives.

5.3 Conclusion

The documentary review identified deficiencies in human resource capacity as a key root cause of problems facing local government, and this manifests as high vacancy levels and accelerated staff turnover rates at senior management levels. The review further indicated widespread appointment to senior positions of officials who lack the necessary competencies and qualifications for those positions. In addition, despite the increasing number of consultants being appointed, there is an absence of skills transfer from consultants to local government employees that perpetuates the shortage of skills within local government organisations. Furthermore, the review highlighted that the organisational culture was essentially unethical, and that this and the ineffective performance management systems were the outcomes of a culture of non-compliance with laws and regulations governing irregular, unauthorised, and fruitless and wasteful expenditure. This duet of unethical culture and ineffective performance management also negatively affected strategic planning, and performance management and reporting. The results of this non-compliance are seen in the high rates of irregular, unauthorised, and fruitless and wasteful expenditure, as well as material findings on the quality of performance reports. The key factor facilitating the high rate of non-compliance was the lack of consequences for transgressions and poor performance.

6 CONCLUSION AND RECOMMENDATIONS

The objective of this study was to identify root causes for non-achievement of objectives by South Africa's local government sector. The results of the literature review indicated four thematic (universal) root causes or common reasons why local government organisations are failing to achieve their service delivery objectives efficiently and effectively. These thematic root causes are an inadequate human resources capacity, widespread shortages of skills, an unethical organisational culture, and an ineffective performance management system. A documentary review of the

AGSA's reports for financial years 2011-12, 2012-13 and 2013-14 was performed in order to identify specific root causes for these thematic root causes.

The results of the documentary review revealed that inadequate human resources was a result of a high vacancy rate amongst senior positions; vacancies which take too long to be advertised and filled; high staff turnover, and recruitment processes which are neither formalised nor streamlined. In addition, the unprofessional, politicised image of and remoteness and poor working conditions in some municipalities was also recognised as contributing to municipalities' failure to attract appropriately qualified professionals to fill vacant positions and thus to improve their service delivery performances. The high staff turnover was mainly caused by differences in salary scales that enable municipalities to poach staff from each other. The review further highlighted that the shortage of skills was characterised by the appointment of people to senior positions who do not have the required qualifications, competencies and skills. In addition, there is a general absence of regular training and development programmes for employees. Although a significant amount is invested in the use of consultants, there is no effective skills transfer to the in-house employees to redress the skills gap, even if contractually required of the consultants.

The unethical organisational culture was mainly evidenced by the high rate of non-compliance with laws and regulations governing irregular, unauthorised, and fruitless and wasteful expenditure. This culture of non-compliance resulted in high rates of irregular, unauthorised, and fruitless and wasteful expenditure (which in some cases were not investigated), nor was there an intention to recover such expenditure where there negligence on the part of specific employees had been identified. In the same vein, the absence of effective performance management systems was also the result of non-compliance with laws and regulations pertaining to strategic planning, performance management and reporting. This resulted in material audit findings on the quality of performance reports. The results of the study highlighted that the main contributing factor to the high rate of non-compliance with laws and regulations was an obvious lack of consequences for transgressions and poor performance.

Based on the thematic and specific root causes identified in the literature and documentary reviews, an analysis was made to further identify the underlying factors which contribute to the existence of these root causes. The results of the analysis revealed that the thematic and specific root causes identified owe their existence mainly to the presence of two all-encompassing root causes. First, there seems to be lack of commitment by the political and administrative leadership to improve the overall performance of the local government organisations and to enforce compliance with laws and regulations. Secondly, there is an almost complete lack of consequences for poor performance and the transgression of statutes and regulations. This implies that there is a relationship between leadership's commitment to uphold laws and regulations and the creation of an environment where the rule of law is respected. Transgressions of laws and regulations should carry clear and swift consequences.

It is therefore recommended that the country's political leadership institutes reasonable measures to address the root causes of the high vacancy rates, the shortage of skills, the widespread unethical behaviour (particularly of senior officials), and the ineffective performance management systems within local government. The recruitment processes should be streamlined to expedite the process of filling the positions. The vacant positions should be advertised in a timely manner, and filled by people who have the required qualifications, competencies, experience and skills. All service level agreements entered into with consultants should contain specific requirements for the transfer of skills, and their implementation should be adequately monitored to ensure that the skills shortage in the public service is effectively addressed. In addition, an effective management system should be established that includes consequences for non-performance and / or misconduct, to improve the leadership's commitment to addressing the occurrence of unethical behaviour, and to monitor and address performance management weaknesses. Persuading leadership to commit to addressing the root causes of non-achievement of objectives, coupled with the implementation of an effective management system may assist in improving the performance of local government organisations.

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Perceptions on the objectivity of local government internal auditors

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ABSTRACT

Internal auditors in the local government sector in South Africa must adhere to the Institute of Internal Auditors' Standards and Ethical Code, both of which regard objectivity to be one of the core principles of internal audit behaviour. This article reports on a study that intended to establish whether or not internal auditors employed in local government understand the IIA's requirements regarding objectivity, and how they perceive and manage their own objectivity. The results show that the majority of internal auditors surveyed do understand the concept, and do realise its importance. Furthermore, perceiving that compromising their objectivity can impact their own effectiveness and that of their internal audit units, they take steps to manage and protect it.

Key words

internal auditor; internal audit unit; objectivity; local government; Institute of Internal Auditors; International Standards for the Professional Practice of Internal Auditing; IPPF, Code of Ethics

1 INTRODUCTION

Internal auditors must clearly separate themselves from management. They must do this by remaining objective in mind and in appearance. Being one of the core principles of the internal auditing profession as portrayed by their Standards and Code of Ethics (IIA 2000:1; IIA 2012:3), this statement is a common belief held by internal auditors - often surfacing when internal auditors are justifying their position in the organisation and refusing to accede to a request from management to assist with certain management or operational functions.

Maintaining objectivity becomes an even bigger challenge as stakeholders in organisations expand their expectations of internal auditors (Verschoor 2012:46). Following the violent death of Lawrence Moepi, a forensic auditor with SizweNtsalubaGobodo based in Houghton, South Africa on 18 October 2013 (Anon 2013), Duncan (2013:1) commented that "Moepi has earned a reputation of being a fraudster's worst nightmare: a fearless, principled, incorruptible auditor" and that "it is widely suspected that he was killed to shut him up". Although Moepi's murder could eventually not be linked to his involvement in fraud investigation, the comments by Duncan regarding his character remains: Objectivity requires internal auditors to be "fearless, principled and incorruptible". The question raised by Mugattash (2011:92), whether internal auditors are still able to maintain objectivity and manage the threats brought about by the expanded expectations, can be rightfully raised again.

2 BACKGROUND

2.1 Professional guidance on objectivity

The Institute of Internal Auditors (IIA) (2012:3) regards objectivity to be one of the fundamental attributes all internal auditors should possess. The IIA's International Professional Practices Framework (IPPF) includes objectivity as part of its Code of Ethics, and reiterates this in their International Standards for the Professional Practice of Internal Auditing (hereafter referred to as Standards). **Principle 7.1.4 of the King report on corporate governance for South Africa (King III) (IOD 2009) recommends that internal auditors comply with the Standards and since the Municipal Finance Management Act (MFMA) require adherence to the recommendations of King III,** it is imperative that every internal auditor possesses an understanding of this concept.

The purpose of the Code of Ethics is to promote an ethical culture in the profession of internal auditing (IIA 2000:1). The second principle of the IIA's Code of Ethics states that 'Internal auditors [must] exhibit the highest level of professional objectivity in gathering, evaluating and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interest or by others in forming judg[e]ments" (IIA 2000:1).

The Standards have been set and are maintained by the Institute of Internal Auditors to define the basic principles of the profession, and to provide a framework for performing value adding services, with the objective of bringing about improvements in the organisation's processes and operations (IIA 2012:1). The Standards have been rewritten on a number of occasions, to maintain their current relevance and practical value (Erasmus, Steyn, Fourie & Coetzee 2013:44). However, the application of the Standards has been subjected to a degree of interpretation, according to the perceptions of individual internal auditors, and internal audit units (Erasmus *et al* 2013:50).

Standard 1100 stipulates that “the internal audit unit must be independent and internal auditors must be objective in performing their work”. In practice ‘objectivity’ and ‘independence’ are often used interchangeably, or worse, they are considered to be synonyms. This might be due to the definitions of the two concepts not being stated clearly enough in the IIA’s Standards, or because the concepts are not fully understood by practitioners. Paape (2007:37) supports this second observation, adding that independence and objectivity are difficult concepts to apply as each situation has its own merits and justifications, and the auditor’s behaviour will be influenced (or nuanced) by his/her response to the situation.

Different views exist regarding the importance for internal auditors to remain objective. Marais, Burnaby, Hass, Sadler and Fourie (2009:897) believe that the internal audit profession stands to contribute greatly to the well-being of their employer organisations, but only if they have the necessary skills and competences to comply with and implement the provisions of the Standards which includes Standard 1100 on independence and objectivity. A willingness and ability to comply with the Standards is regarded as a crucial step in ensuring that internal auditors are effective and best serve their organisations. This is why King III recommends that internal auditors should comply with the Standards. (Sadler, Marais & Fourie 2008:137; IOD 2009). It also seems that South African internal auditors in general make an effort to comply with the Standards. Results from both the CBOK 2006 and the CBOK 2010 studies show that South African organisations achieved high scores in terms of complying with the Standards when compared to other regions across the world (Marais *et al* 2009:890; Erasmus *et al* 2013:50). This was considered remarkable as other regions received lower scores despite having bigger and more sophisticated economies than South Africa, and having been part of the IIA for far longer (Erasmus *et al* 2013:50). In the CBOK 2010 study 81.54 % (CBOK 2006: 92.7%) of South African organisations surveyed reported compliance with the Independence and Objectivity Standard (Standard 1100) (Marais *et al* 2009:890; Erasmus *et al* 2013:50).

A notion however exists among management and boards of some organisations that strict compliance with the Standards would not add value to the organisation. (Erasmus *et al* 2013:46-47). This is evident from the reasons offered for non-compliance with the Standards during the CBOK 2006 study which included views that “management of the organisation don’t think it adds value” and “management of the organisation do not support compliance” (Sadler *et al* 2008:136). Fourie Plant, Coetzee & Van Staden (2013:82-83) later also observed that both in South Africa and globally, internal audit managers do not perceive objectivity to be overly important, and that a standard definition of what objectivity entails was lacking.

Despite the differences of opinion that may exist, internal auditors in the local government sector adhere to the Standards and the IIA’s Code of Ethics (see Section 2.2 below). Their adherence to the Standards and ethical principles, as they relate to supporting objectivity, may however put them in a position of conflict with the views of their stakeholders referred to above.

22 Internal auditing in the South African local government sector

The purpose of the local government sector in South Africa is accurately articulated by the Auditor General South Africa in his 2014 report on local government institutions (Auditor General South Africa 2014:22):

“The Constitution of South Africa determines that local government must structure and manage its administration and budgeting and planning processes to give priority to the basic needs of the community, promote the social and economic development of the community and participate in national and provincial development programmes”. Legislation, such as the Municipal Finance Management Act, 2003 (Act No 56 of 2003) (MFMA) and the Municipal Systems Act, 2000 (Act No. 32 of 2000) adds definition to the manner in which local government must function in order to achieve these developmental objectives, by insisting on sound financial and performance management, and on accountability to the communities it serves (RSA 2000; RSA 2004).

Internal auditing is still a fairly new professional practice in South Africa’s local government sector, only achieving widespread practice after the promulgation of the MFMA (Act No. 56 of 2003). Internal audit units assist managers and the chief executive officers of municipal entities in the execution of their duties by providing independent assurance on internal controls, financial information, risk management, performance management and compliance with legislation (Auditor General South Africa 2014:87). Section 62(1)(c)(ii) of the MFMA requires internal auditors to comply with any prescribed norms and standards (RSA 2004). The Act does not indicate which “norms and standards” legislators had in mind, but the King Code on Corporate Governance for South Africa (IoD 2009), that applies to local government organisations, recommends in Principle 7.1.4 that internal auditors should abide with the Standards and the Code of Ethics of the IIA at a minimum.

The findings published in the Consolidated general report on the audit outcomes of local government 2012-13 (Auditor General South Africa 2014:87) attest to the immaturity of the internal auditing function in local government, and the negative impact that this has on its effectiveness; almost 80% of local government internal audit units are not achieving the expectations of the Auditor General. The report however also draws approving attention to the contribution made by 22% of the internal audit units in improving internal controls and impacting positively on audit outcomes (Auditor General South Africa 2014:87). The fact that internal auditing in the local government sector in South Africa is still in its infancy implies that internal audit practices may be prone to mistakes that may arise from misinterpretations or being unaware of certain Standards.

This section of the article aimed to provide background information on two core concepts underlying the study, i.e. the importance of objectivity and internal audit practices in local government. The purpose and significance of the study as well as the research design and methodology will be described next, followed by a discussion of the literature review and the results of the empirical research.

3 PURPOSE AND SIGNIFICANCE OF THIS STUDY

Considering the value attributed to objectivity by the internal audit profession, this article describes a qualitative study of local government internal auditor's perceptions on their objectivity. The overall aims of the study was to examine four key areas: whether or not internal auditors understand the concept of objectivity; how they perceive their own objectivity; how they perceive their objectivity to impact on their own effectiveness, and how they perceive their objectivity to impact on the internal audit unit's effectiveness. The study also sought to determine what types of threats to objectivity internal auditors in local government institutions are exposed to, and how internal auditors manage these threats to their objectivity. Research on internal auditing in local government in South Africa is limited. This article sheds light on current practices of internal auditing in this sector specifically pertaining to internal auditors' objectivity. The findings of the study may assist local government authorities and the Auditor General to address threats to objectivity generally, and specifically to improve the objectivity of their internal audit functions. The findings may also be useful to organisations in other sectors of government, and in the private sector, to subject the objectivity of their internal auditors to scrutiny. Individual internal auditors may benefit from the study by using it as a reference point against which to evaluate their own perceptions, and thus enabling them to correct any misperceptions they may have regarding their objectivity.

4 RESEARCH DESIGN AND METHODOLOGY

4.1 Methods of data collection

The research upon which this article is based consisted of a literature review and an empirical study. Internal auditing standards and practices relating to the objectivity of internal auditors were examined and served as a theoretical background to and basis for the empirical study. The empirical study followed a quantitative approach which according to Creswell (2009:3) is "a means of testing objective theories by examining the relationship among variables". A cross-sectional survey method was used whereby questionnaires were sent out to local government internal auditors to obtain the perceptions of their objectivity. A computer aided, self-administered survey (Tustin *et al* 2005:20) was conducted whereby questionnaires were sent (via e-mail) to 65 out of a 110 internal auditors cumulatively employed by one metropolitan municipality, 5 district municipalities and 18 local municipalities, all situated in one of South Africa's nine provinces. A clustering sampling method was used by which the questionnaires were sent to the heads of the internal audit units and the heads then distributed the questionnaires to their subordinates fulfilling different roles and at different levels of seniority within the different internal audit units: i.e., senior internal auditors audit supervisors and junior internal auditors. The responses were collected and returned through the respective heads of the internal auditing units. A probability sampling method was used for selecting the internal audit units to participate in the survey as they were selected merely because of accessibility for research purposes and not for any other particular reason. Because the agreement between the researchers and the participating internal audit units included an undertaking to maintain the anonymity of respondents, no data was sought regarding the specifics of the institutions in which the respondents worked.

The questionnaire was compiled by an MPhil student in the Department of Auditing at the University of Pretoria and presented to an academic and senior staff in the local government institutions for their revision and input before it was distributed to the participants. The questionnaire has four sections. The first section aims to determine the profile of the respondents and to establish their levels of awareness of the Standards. Section 2 serves as an objectivity awareness assessment, while Section 3 aims to establish how objectivity is being managed within the respondents' local government institutions. Section 4 requires respondents to reflect on their own objectivity and how they perceive their objectivity to impact on their individual effectiveness and on that of the internal audit unit they work for.

4.2 Responses

The survey resulted in 45 usable responses which represents a 69% response rate. The response rate is considered reasonable considering that Tustin *et al* (2005:193), quoting Sudman & Blair 1998:166, claim that a response rate of 70% or more is possible where "highly educated response groups such as doctors, lawyers and accountants are surveyed about topics relevant to their professions". Of the 45 responses received, 22% were completed by the head of the internal audit unit (CAE), 40% by senior internal auditors or supervisors, and 38% by junior internal auditors. After proper codification of the completed questionnaires, the responses were captured on an excel spreadsheet for statistical analysis. A descriptive analysis approach was followed, the aim of which is described by Tustin *et al* (2005:103) as "to provide a summary of the population in terms of the variables of interest".

4.3 Limitations of the study

The study is limited to investigating the perceptions of internal auditors in the local government sector of a single province in South Africa. It may therefore not be representative of internal auditors in other provinces or the South African public sector in general, nor the private sector or internal auditors in other countries. The selection of the population surveyed was based exclusively on accessibility considerations, meaning that auditors who were on leave or on remote assignments at the time of the survey were excluded from the population. Responses should therefore not be regarded as automatically representative of all local government internal auditors as cultural, economic and geographic circumstances amongst others could well affect perceptions of internal auditors in different regions.

The objectivity awareness assessment (Section 2 of the questionnaire) included questions with one correct answer. Participants did however not necessarily complete the questionnaire in privacy and could have consulted with other participants to test their answers and returned their completed assessments via the head of internal audit. Although the result of the assessment serves as an indication of the internal auditors' awareness, knowledge and understanding of objectivity, the test should be written under examination conditions and returned directly to the researcher to provide a more accurate and reliable assessment.

5 LITERATURE REVIEW

According to the IIA's Standard 1100, "The internal audit unit must be independent, and internal auditors must be objective in performing their work." (IIA 2012:4)

The glossary section of the Standards defines objectivity as a state of mind that is required from internal auditors for them to be able to perform their duties diligently and without having to compromise the quality of their work (IIA 2012:22). Internal auditors are required to resist subordinating or deferring their judgement to that of others when it comes to audit matters. Independence, on the other hand, is defined as freedom of the internal audit unit from conditions that can cause bias (IIA 2012:21). From the definitions it is noticeable that **objectivity** has to do with each individual internal auditor whereas **independence** has to do with the internal audit unit as a whole.

The IIA's Code of Ethics also requires that internal auditors uphold the principles of integrity, competence, confidentiality and *objectivity* and failure to uphold any of these principles is considered a breach of the Code (IIA 2000:1).

Objectivity is one of the most critical behavioural skills expected of internal auditors and it is essential to the maintenance of their credibility, the quality and reliability of their work, and to ensure the effectiveness of the internal audit unit (Brody & Lowe 2000:171, Fourie *et al* 2013:76; Ridley 2009:72; Soh & Martinov-Bennie 2011:615). Mutchler (2003:233) attests to this, writing that without objectivity the other three principles, i.e. integrity, confidentiality and competency, are insufficient to allow internal auditors to provide value-adding services. In addition, Barret (1999:8) regards objectivity as one of the essential attributes that enables colleagues to regard internal auditors as valuable members of the organisation, well-equipped to contribute to its efficient operation. However, Feltern (1995:30) remarks that internal auditors do not need to distance themselves from auditees for fear that, should they become accustomed to the auditee and their issues, they will become overly sympathetic and lose objectivity. The consequence of a distant approach was found by Feltern (1995:32) to manifest as a breach of trust and a failure to generate a culture of mutual cooperation between the auditor and the auditee.

The Standards (Standard 1110, 1120, 1130 and 1130.A1) provide guidance to internal auditors on how objectivity should be maintained and managed. Views prevalent in the literature regarding these standards are discussed next.

Standard 1110: states: "The chief audit executive must report to a level within the organization that allows the internal audit unit to fulfil its responsibilities." (IIA 2012:4)

Internal auditors' lack of independence from senior management in the organisation is automatically seen to threaten their objectivity (Gallegos 2004:37; Stewart & Subramaniam 2010:330). Gallegos goes on to explain that a situation where the internal auditors report to the chief financial officer (CFO) may be an effective breach of objectivity as the CAE will be seen to be in a position where s/he needs to be overly mindful of the internal audit function's findings and the opinions they issue, as the CFO controls their budget and may terminate the employment of the CAE (Gallegos 2004:37).

Chun (1997:247), noting that auditors have a duty to make managers accountable for their functions in the organisation, recommends that the organisational status of internal auditors should enable them to report to a level higher than that of their auditees.

The implementation of Standard 1110 usually has the CAE reporting functionally to the board (which normally implies the audit committee) and operationally to management (usually the CEO) (IIA 2012:4). Some authors have positive views regarding this reporting relationship, stating that the audit committee is supposed to serve as a safeguard of the internal auditor's objectivity (Stewart & Subramaniam 2010:333), and that an effective audit committee is said to strengthen the objectivity of internal auditors (Muqattash 2013:30). However, it is also suggested by others that reporting to an ineffective audit committee may compromise the internal auditor's objectivity, (Rose & Norman 2008:9) as such circumstances may allow the internal auditors to make their own decisions regarding what they include in their reports to the audit committee (O'Leary & Stewart 2007:796). Dual reporting is however recommended in Practice advisory 1110-1 (IIA 2012) and common practice in many organisations.

Standard 1120 stipulates: "Internal auditors must have an impartial, unbiased attitude and avoid any conflict of interest."(IIA 2012:4)

Ahlawat and Lowe (2004:156) offer a notion that objectivity is a myth. They believe that the relationship between employer (senior management and/or directors) and internal auditor inevitably creates an environment that can potentially influence or distort the judgement of the internal auditor. This was evident in their study of internal audit's role in a merger transaction where it was found that internal auditors favoured their current employers. Stefaniak, Houston and Cornell (2012:42-43) almost concur with Ahlawat and Lowe when they posit that the employer/internal auditor relationship can fall into a state that psychologists refer to as "social identification". According to Stefaniak *et al* (2012:42) this theory says that the extent to which a person feels attached to a particular group will affect their objectivity as it pertains to that group.

There are recognised circumstances that can induce bias in an internal auditor's opinions. Gallegos (2004:38) records that an internal auditor's desire to partner with management has been known to distort audit opinions. Dezoort, Houston and Peters (2001:265) posit that where internal auditors are performing a consulting engagement that is subjective in nature, and includes a compensation incentive, their objectivity may be affected. Ridley (2009:72) further points out that a breach of the objectivity requirement comes about when internal auditors fail to apply a systematic process to evaluate and recommend improvements to the area audited.

These situations, however, also depend on the individual internal auditor's attitude. A study was conducted by Church & Schneider (2011:15) to determine whether there was substance to an observation made by the General Accounting Office of the United States that participating in decision-making in current operations or in areas soon to be audited would result in the internal auditor being impartial. The outcome of the study was that the auditors may still remain objective despite having been involved in the design of the process they were then called on to audit (Church & Schneider 2011:22).

Standard 1130 stipulates that: "If independence or objectivity is impaired in fact or appearance, the details of the impairment must be disclosed to appropriate parties" (IIA 2012:5).

Objectivity is difficult to measure and for that reason independence is often looked at as an alternative to determine if there is a potential for bias (Mutchler 2003:243). To management, generally, internal auditors exist to serve their interests, and reporting to the audit committee is merely to satisfy a governance requirement (Christopher, Sarens & Leung 2009:203). Van Peursem (2005:507) claims that internal auditors are expected to use the standard lines of communication to clear any ambiguity they may face in their audit roles, and it is up to the internal auditor to educate management on potential threats to objectivity, and to report to the audit committee and to request its intervention wherever there is a need.

Finally, Standard 1130.A1 states: "Internal auditors must refrain from assessing specific operations for which they were previously responsible." (IIA 2012:8)

Providing both assurance and consulting services to the same audit client has frequently been raised as an issue that threatens objectivity (Stewart & Subramaniam 2010:328) although it was pointed out by Selim, Woodward & Allegrini (2009:21) that the threat is dependent on the nature of the consulting services provided. Since internal auditors, through consulting, may engage themselves in operations that they may later have to audit they need to ensure that they tread carefully and ensure that their competence and independence will not eventually be questioned (Bou-Raad 2000:184).

From the foregoing discussion it is evident that maintaining objectivity is a challenge for internal auditors due to the changing environment that they find themselves working in. It is for this reason that the IIA developed its *Practice Guide: Independence and objectivity*. This practice guide identifies instances that can affect objectivity and provides a framework for evaluating and managing threats to objectivity. The framework also provides tools that can be applied to manage threats. Whilst the tools are not meant to be exhaustive, they do cover a wide spectrum of the threats (IIA 2011:1).

Internal auditor objectivity can be threatened in various ways by factors such as social pressure, economic interest, personal relationships, familiarity and bias related to culture, gender, age and cognitive abilities. (IIA 2011:7-8). The Practice Guide places responsibility for identifying and managing threats to objectivity on individual internal auditors, and expects them to mitigate the threats identified. The preservation of objectivity thus depends on the individual internal auditor's professionalism as well as that of their supervisors (IIA 2011:4).

There are a variety of ways in which threats can be managed. The following mitigation factors may be considered: Having hiring policies that provide for screening of applicants for potential objectivity threats, such as family relationships with senior management or main suppliers; training internal auditors to identify threats; enhancing supervision of internal audit engagements to reduce internal auditors' bias; quality assurance reviews; implementation of a team approach to internal audit engagements including rotation of teams or reassignment of members, and outsourcing. (IIA 2011:9).

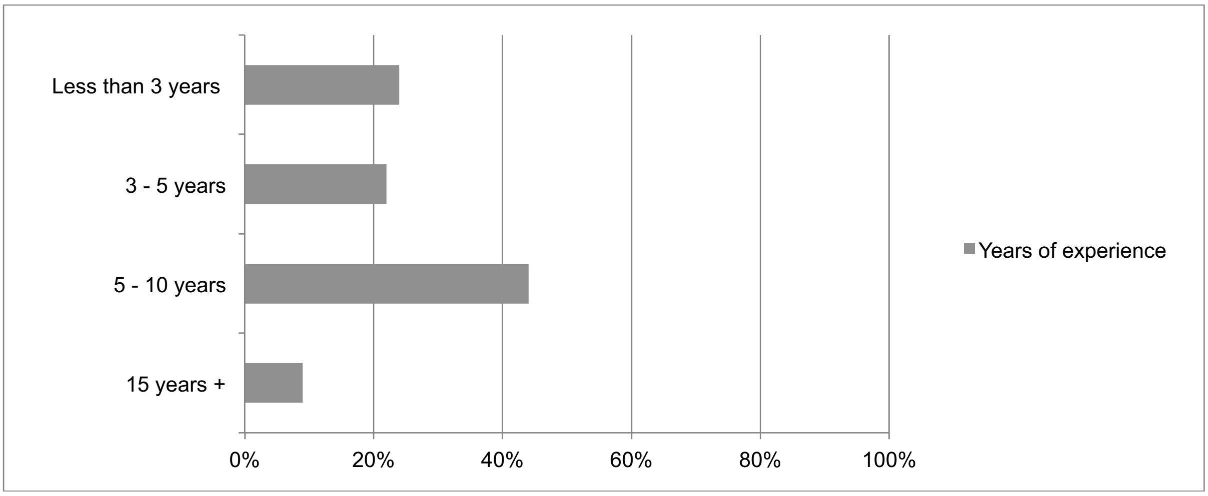
From an organisational level the threats could be managed through positioning the internal audit unit at an organisational level that assures them of independence; introducing and vigorously implementing policies that identify the importance of objectivity and protect it; creating an environment and mind-set within the organisation that is receptive to internal audit findings and recommendations, so that internal auditors are not inhibited from raising contentious issues; offering rewards for objective thinking and applying punitive process for biased conduct. The use of teams, peer review and internal consultation can mitigate the risk of individual breaches of objectivity. (Mutcher 2003:253-255). Where none of the mitigation factors and tools are successful in managing the threat, the threat and the failed remedies should be disclosed to the audit committee (IIA 2011:9).

6 EMPIRICAL RESEARCH FINDINGS

6.1 Profile of respondents and general awareness of the internal auditing standards

The first section of the questionnaire aimed to determine the professional and demographic profiles of the participants. Respondents were requested to indicate their employment level in the internal audit unit, their years of experience as internal auditors, whether they have a qualification in internal auditing, and whether they are members of the IIA. The majority of the responses came from senior and supervisory level internal auditors (reflected, as expected, in the significant number of respondents with between 3 and 10 years' experience), followed by junior internal auditors (with less than 3 years' experience). The years of experience claimed by the internal auditors and shown as Figure 1 does reflect that internal auditing in the local government sector is still in its infancy as 46% of respondents have less than 5 years' experience. Considering that the MFMA was only promulgated ten years ago, and that the supply of qualified internal auditors is limited, the fact that internal auditors have amassed as much experience in the public sector as they have indicates that local government is in fact doing quite well in recruiting experienced internal auditors.

Figure 1: Years of experience as internal auditors



Further analysis indicated that 90% of CAEs have between 5 and 10 years' experience, 72% of senior internal auditors and audit supervisors have more than five years' experience and all respondents with less than 3 years' experience are on the junior internal auditor/officer level. Offering additional encouragement is the fact that 91% of the total respondents (and 88% on the junior/officer level) have a qualification in internal auditing, suggesting that although they may have limited practical experience, the majority have been introduced to the field of internal auditing through their studies.

As indicated earlier in this article, local government internal auditors must comply with the Standards. Furthermore, internal auditors who are also members of the IIA are also required to uphold the IIA's Code of Ethics, and are regularly kept abreast of changes and developments in the profession. It is concerning therefore that only 71% of the total number of respondents indicated that they are members of the IIA. Although more than 80% of the respondents employed at a senior or supervisor level indicated that they were members of the IIA, it is particularly worrying that 30% of CAEs and 41% of junior internal auditors are still not IIA members.

Membership of the IIA should be encouraged for all internal auditors, regardless of rank. Group membership for internal audit units and student membership for its junior internal auditors may be considered and negotiated, perhaps by the provincial chapters of the local government association (SALGA), so that more internal auditors can afford to become IIA members.

The majority of internal auditors surveyed confirmed that they have access to the IPPF (89% of all respondents), and rated their own understanding of the Standards to be good (78% of all respondents; CAEs - 90%; senior internal auditors - 89%, and junior internal auditors - 59%). Junior internal auditors perceive themselves to understand the Code of Ethics, with 76% responding that they have a *good understanding* (CAEs - 90%; seniors -89%), and 13% of all internal auditors indicating that they have a *fair* understanding. This is logical as internal auditors' understanding of the Standards grows with practical experience, while the Code of Ethics, as a set of more abstract concepts, is less reliant on practical experience for full understanding to be achieved.

Respondents were requested to indicate to what extent they were able to apply the IIA's Standards and Code of Ethics in the performance of their day-to-day responsibilities as internal auditors. 91% of the respondents indicated that they were able to apply the IIA's Standards in their day–to-day activities as internal auditors at the municipalities (either *always* or *most of the time*). 9% of respondents only managed to apply the IIA Standards *sometimes*. No respondents chose the *seldom* response option. Even more respondents (93%) indicated that they were able to apply the Code of Ethics in their day-to-day activities as internal auditors at the municipality (69% *always*, and 24% *most of the time*). However, 7% of the respondents opted for the *seldom* option. 100% of senior auditors and supervisors were confident that they could apply the IIA's Code of Ethics in their day-to-day responsibilities, of which 78% responded *always*.

The last two questions in Section 1 of the questionnaire required the respondents to report on the frequency of receipt of updates or training on the Standards and on internal audit practice. Responses indicated that more emphasis is placed on training related to internal audit practice than on the Standards. While not ideal, this is acceptable as most of the internal auditors have a qualification in internal auditing, and also indicated that they have access to the IPPF. 56% of respondents indicated that they receive training on the Standards at least once a year, and 69% of respondents claimed to receive training on internal audit practice at least once a year. Training seems to occur more often at the senior auditor and supervisor level where 83% of respondents indicated that they receive *frequent* training on both the Standards and internal audit practice.

6.2 Objectivity awareness assessment

The second part of the questionnaire intended to assess the respondent's knowledge of and ability to give effect to objectivity. Each of the 14 questions in this section has a correct answer. Seven questions are purely knowledge-based and tested the respondent's knowledge (recall) of the Standards and Code of Ethics regarding objectivity, and ability to distinguish the difference between independence and objectivity. Four questions tested the respondent's interpretation and understanding of the IIA's Standards and Code of Ethics: i.e. did the respondent know how the knowledge should be applied in practice. Four other questions tested the respondent's grasp of the concept of objectivity as applied in practical situations.

Respondents in total scored 77% for the awareness assessment (CAEs - 81%; senior auditors and supervisors - 77%, and junior internal auditors - 74%). Further analysis of the responses explored respondents' facility with theory, interpretation and ability to apply concepts. The junior internal auditors achieved an "average" score for the theoretical questions compared to the with destinction level achieved by CAEs and seniors. In addition juniors did less well in the questions that tested interpretation of the Standards and ability to utilise the concept of objectivity. CAEs showed a higher level of understanding of the concept and interpretation of objectivity than their juniors, while senior auditors obtained the best score for knowledge of objectivity component of the Standards. The response to Section 2 of the questionnaire presents an encouraging level of awareness and knowledge of the concept of objectivity amongst the local government internal auditors surveyed. This awareness includes an ability to differentiate between objectivity and independence, which the literature study indicated is challenging.

6.3 Managing objectivity

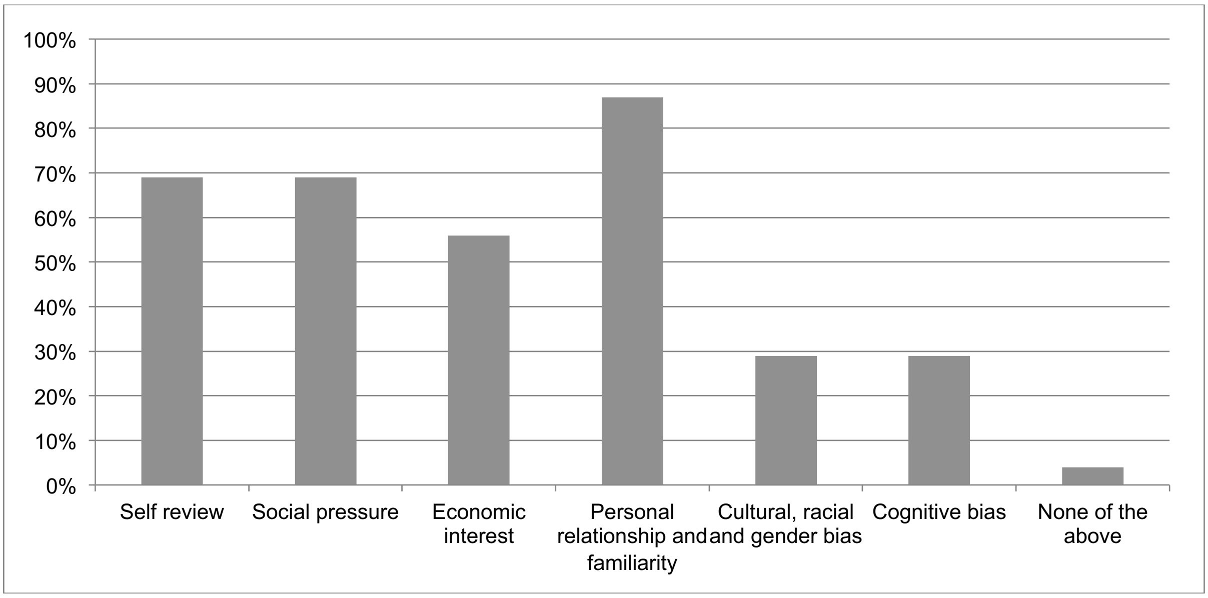
The third section of the questionnaire set out to determine how respondents perceive their responsibility to remain objective, what internal auditors perceive to be threatening their objectivity, and what is being done to manage these threats and to promote objectivity either by the organisation or by the internal audit unit itself. Most of the questions in this section used criteria from the IIA's Practice Guide on objectivity, and additionally prompted respondents to provide more information where appropriate.

One of the questions asked respondents to indicate whether or not the IIA's framework for managing threats was being applied in their organisation. Responses indicated that there appears to be a low degree of familiarity with and application of the framework as such. However, CAEs appear to be more familiar with the framework than are their subordinates.

The majority of the respondents (82%) understood that they (collectively) have a responsibility to manage threats to their objectivity. However, only 13% perceived the managing of threats to objectivity to be their individual responsibility, while 69% perceived it to be a combined effort involving the CAE and the individual auditor. Some respondents (30% of CAEs and 17% of senior auditors and supervisors) perceived the responsibility to manage threats to objectivity to be that of an outside party such as the audit committee and/or accounting officer. Although none of the junior level auditors selected either of these options, 88% of them indicated that the responsibility was either shared by the CAE and the internal auditor, or was the sole responsibility of the CAE.

Of the threats to objectivity listed in the IIA's Practice Guide (IIA 2011:7-8), respondents saw *personal relationships/ familiarity with the auditee* to be the greatest. This was followed by *self-review* (auditing work for which you had operational responsibility) and *social pressure* (pressure arising when the auditor is too close to the auditee). *Economic interests* also received a fairly high response (56%) while *cultural, racial and gender biases*, as well as *cognitive biases* received responses below 30%. Two respondents from the senior auditor/supervisor level (4% of all responses) do not perceive any of the items listed as threats to their objectivity. Respondents' perceptions regarding possible threats to their objectivity are presented in Figure 2. Respondents identified using the services of independent consultants to complement the services of the internal audit activity (co-sourcing) as another possible threat.

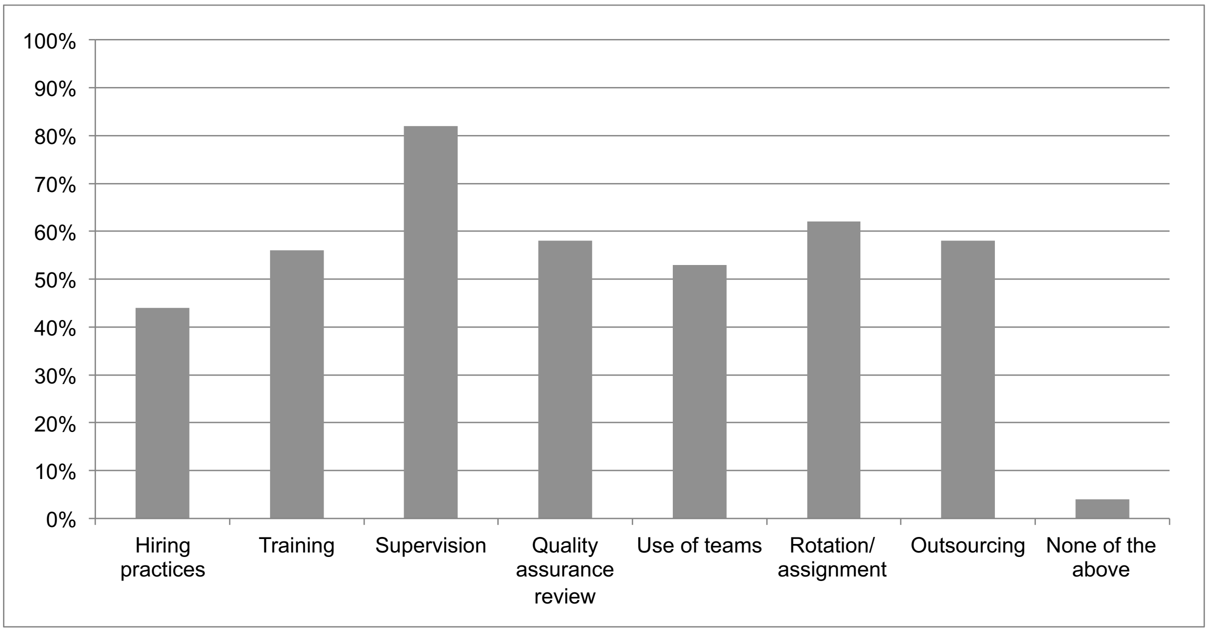
Figure 2: Rating of possible threats to objectivity



Most of the respondents (60% of the total) indicated that management does not apply specific tools to manage threats to objectivity since they regard the task to be the responsibility of the individual internal auditors. The balance of the respondents indicated that management does apply tools to manage threats to objectivity, and mentioned *reporting lines*, *declaration of interests, internal methodology,* and *management support* as those tools most frequently applied by their management teams.

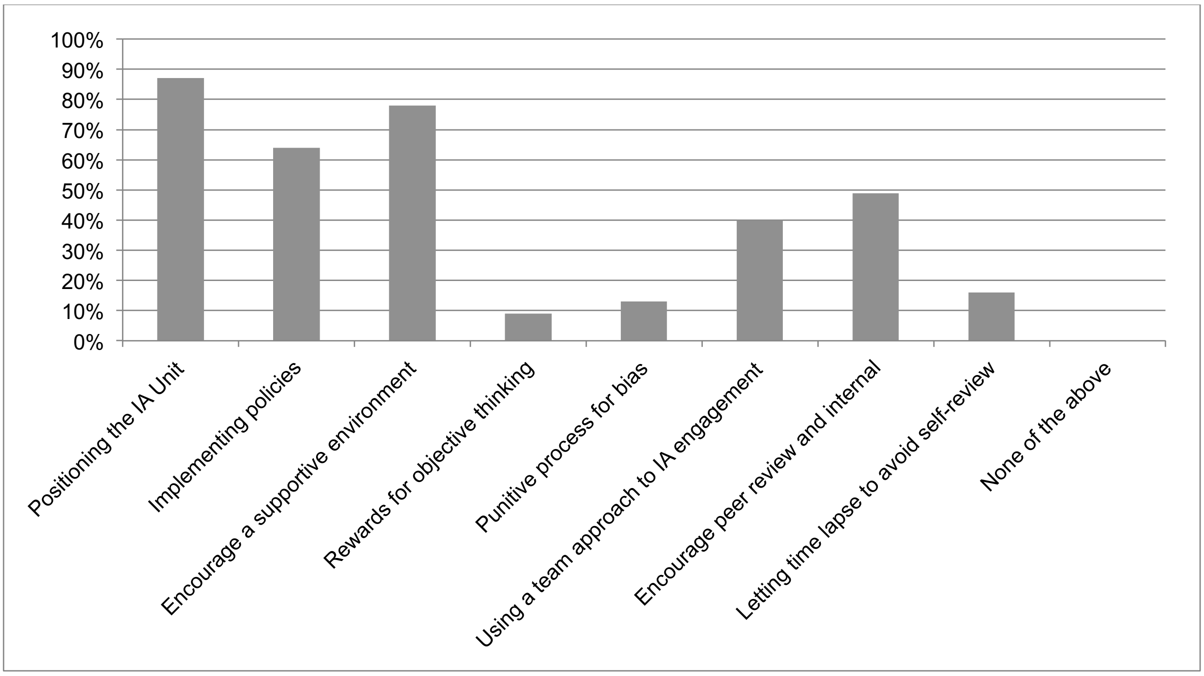
Respondents were then required to identify the objectivity management tools they observed being used by the municipality. The list was obtained from the IIA's Practice Guide (IIA 2011:8-9). The most frequently selected tool was *supervision*. If seen together with the response to the earlier questions where it was evident that buy-in from a superior is regarded as an important component in managing threats to objectivity, the preference for this tool is logical. Figure 3 presents the management tools that were reportedly being used at organisational level. No further suggestions were made by any of the respondents.

Figure 3: Objectivity management tools applied by municipalities



Respondents were also asked to identify the initiatives applied by their organisations to promote the objectivity of internal auditors. The list of initiatives offered was obtained from the IIA's Practice Guide, and respondents were also invited to identify initiatives not listed. The response is depicted in Figure 4.

Figure 4: Initiatives applied by municipalities to promote the objectivity of internal auditors



The initiative most frequently recognised as having been implemented by the municipality to promote the objectivity of internal auditors was *positioning the internal audit unit to ensure their independence and authority.* This was followed by *encourage a supportive environment for accepting internal audit findings and recommendations*, *implementing policies* and *encourage peer review and internal consultation*. Junior internal auditors identified the *supportive environment for accepting internal audit findings,* while the majority of CAEs identified *the positioning of the internal audit unit* and *policies and procedures* as their preferred initiatives. Senior internal auditors identified *a team approach* and *encouraging peer review and internal consulting* as important initiatives. *Outsourcing* and *quality assurance reviews* were mentioned as tools that could also be applied to promote the objectivity of internal auditors. *Rewards for objective thinking*, *punitive processes for bias* and *letting time lapse to avoid self-review threats* were less-frequently observed initiatives.

As was reported in the literature review, the independence of the internal audit unit has an effect on the objectivity of the internal auditors. Following up on this, respondents were asked who their internal audit units report to. All (100%) of the internal auditors indicated that their IA units had dual reporting relationships - with the accounting officer and the audit committee. As this is required by section 165 (2)(b) of the MFMA the fact that one respondent did not answer this particular question was not deemed material.

6.4 Effect of objectivity on the effectiveness (accomplishing of objectives) of internal auditors and internal audit activities

The first question in this section asked respondents whether they were able to remain objective while performing their-day-to-day responsibilities as an internal auditor in their organisation. Whilst respondents had admitted to experiencing challenges to their objectivity in the previous section of the survey, in this section 98% of respondents recorded that they were able to maintain objectivity at least *most of the time* (this included the 62% who claimed that they were *always* able to maintain objectivity). It is interesting to note that CAEs admitted to finding it more difficult to *always* remain objective than did the other levels of internal auditors. Only 30% of CAE respondents indicated that they were *always* able to remain objective, while 72% of senior auditors and 71% of junior auditors claimed they had perfect records. 60% of CAEs were able to maintain objectivity *most of the time* and one CAE admitted that it was achieved only *sometimes*. All the internal auditors on the other levels claimed to be able to maintain objectivity at least *most of the time*.

In response to the final questions the majority of respondents from all levels believed that their objectivity has an impact on their own effectiveness as well as on the effectiveness of the internal audit unit as a whole.

7 CONCLUSIONS AND RECOMMENDATIONS

The purpose of this article was to report on a study that aimed to determine whether or not internal auditors in the local government sector in South Africa understand the concept of objectivity, how they perceive their own objectivity, and what they perceive the impact to be of their objectivity on their own effectiveness, and on that of the internal audit unit. The article also reported on the types of threats to objectivity that internal auditors in local government institutions are exposed to, and concluded with perspectives on how these threats to objectivity are managed. To this end, internal auditors in various positions in the internal audit units of local government institutions located in one of the nine

South African provinces were surveyed. A total of 65 questionnaires were sent to internal auditors in these institutions, and 45 usable responses were received.

The results showed that internal auditors at local government level are aware of, and have a good understanding of the IIA's Standards, and the requirements of its Code of Ethics as they relate to objectivity. This result is in agreement with the CBOK 2006 and 2010 studies, which also indicated a high level of understanding of and compliance with Standard 1100 (dealing with independence and objectivity) amongst South African respondents (IIA 2012:3).

The overall conclusion is that local government internal auditors collectively have an adequate knowledge of objectivity. They understand its components and fragility, and the need to manage threats to it. They perceive objectivity to be a factor that, if lost, can compromise the effectiveness of the internal audit unit. However, there are significant differences in responses evident between the levels of seniority of internal auditors when determining the levels of understanding of the IIA's Standards and of the concept of objectivity and its practical manifestations. In spite of these differences, the majority of the internal auditors understand their individual responsibilities to manage threats to objectivity. Whilst they do face common threats to their objectivity (and some more than others), they are however able to maintain their objectivity through implementing some of the IIA-recommended objectivity management tools. Of these tools, support from the organisation's senior management was seen as the most important in managing threats to objectivity.

The infrequency of training opportunities was highlighted in the summary of the results, and could be the cause of the discrepancy in the perceptions of the different levels of seniority of internal auditor. Training sessions usually have financial implications, with long term positive returns on investments being required by the MFMA amongst others. In that light, spending the training budget on senior staff members who are more likely to stay in their positions than their junior counterparts makes sense. The CAE and audit supervisors indicated that they attend training sessions more frequently than do their junior colleagues. This should then place them in a position to train their juniors. However, this question was not specifically researched.

Municipalities should take the steps necessary to ensure that the internal audit unit has a staff complement that embodies and practices the principles set out in the IIA's Standards and Code of Ethics. Membership of the IIA has a requirement that members comply with the Standards and the Code of Ethics, and that members should keep abreast with developments in the profession. Municipalities, would thus, by encouraging membership of the IIA (SA) ensure that their entire internal audit team is afforded all possible assistance to keep their professional competence current. Membership of the IIA is however not the only way to improve the understanding of internal audit concepts. By introducing specific training on the implementation of both the Standards and the International Professional Practices Framework (IPPF) internal audit practice could also be protected against attacks on its objectivity. This could also bridge the gap between the perceived competencies of the CAEs and their subordinates, from the point of view of their respective abilities to understand the concepts of objectivity and independence, and to interpret them and then to apply them.

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Share incentive schemes for Chief Audit Executives

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ABSTRACT

The use of share incentive schemes as part of the remuneration structure for the head of internal audit or the Chief Audit Executive (CAE) is one mechanism available to a company to incentivise its senior executives and to ensure they add value to the company they manage. This can however lead to challenges as internal auditors have always had to fulfil two contradictory roles: being an employee in a company and being an objective person involved in rendering independent assurance services for the same company. It is, therefore, important for internal auditors to strike the correct balance that ensures they are perceived as sufficiently independent to achieve their objectives in terms of the annual internal audit plan. Care must also be taken to ensure that the share incentives do not have a negative influence on the level (or perceived level) of independence and objectivity the CAE demonstrates.

This is the first South African study to investigate the use of share incentive schemes for CAEs. This study used structured interviews in a multiple case study approach to identify the views of the chairpersons of audit committees (CACs) on the use of share incentive schemes for their CAEs. The study found that share incentive schemes were used to incentivise CAEs mostly over the medium term. The study also found that although the CACs had little oversight over the remuneration of the CAEs, they nevertheless did consider the use of share incentive schemes to be an acceptable remuneration mechanism.

Key words

Chief Audit Executive; objectivity and independence; share incentive schemes; incentives; internal auditors

1 INTRODUCTION

Share incentive schemes have recently received a lot of adverse attention in the press, especially in the banking environment. Treanor (2014) reports that Barclays paid out shares worth £32 million to its management team, despite the fact that profits were down and the share price had dropped. In South Africa share incentive schemes have also been in the limelight, with the level of the share incentives awarded to some executives being questioned. For example Shoprite's Chief Executive Officer (CEO) exercised a total of R594 million's worth of share options in 2010. This astronomical figure drew criticism as 48% of the people in South Africa at the time were living below the poverty level of R322 per month (Carte 2011).

Recognition of the importance of good corporate governance is a key aspect of business that has helped South Africa to adapt (after democratisation in 1994) to a more competitive global environment. Formal guidance on good governance practices started, in South Africa, with the *King Report on Corporate Governance (King I)* in 1994. This has evolved through a second report *(King II)*, issued in 2002, to the third revision, known as the *King Code of Governance for South Africa 2009 (King III)* and published by the Institute of Directors in Southern Africa (IoDSA) (IoDSA 1994, 2002, 2009). *King I* advocated an integrated approach to good governance principles, in the interest of profits for shareholders, while *King II* shifted from emphasising a single to a triple bottom line which focused on the economic, environmental and social aspects of business affecting the sustainability of the organisation (IoDSA 1994, 2002, 2009). In the *King III* report more principles were articulated that specifically recommended improved oversight by and responsibilities for the audit committee. This recommended increase in governance was endorsed by the new *Companies Act*, which strengthened the role of the Audit Committee by making it a statutory committee with legislated responsibilities (RSA 2008: section 94). The value of oversight is highlighted by Li (2010:38), who analysed the failure of Enron, and found that a lack of independent oversight over Enron's management contributed to the collapse of the company. *King III* recommends (in principle 3.7) that the "Audit Committee should be responsible for the appointment, performance assessment and dismissal of the Chief Audit Executive (CAE)", thus making oversight over share incentive schemes the responsibility of the Audit Committee (IoDSA 2009: principle 3.7).

The aim of this article then, is to explore the use of share incentive schemes as a remuneration option for CAEs. To achieve the research aim this article considers the following:

- The views of the chairpersons of the audit committees (CAC) of selected companies on using share incentive schemes as part of the remuneration of CAEs;
- The impact of share incentive schemes on the objectivity and independence of the CAE, and
- The oversight role played by the audit committees over the implementation of share incentive schemes benefitting CAEs.

A multiple case study approach was used to gather evidence from seven JSE-listed companies. According to Yin (2003:1-2), a case study is suitable when investigating a "real-life event", like the use of share incentive schemes as a remuneration component for CAEs. A literature review on share incentive schemes for executives was pursued in order to identify key aspects of the issue, and to develop the questions used in the case studies. The questions were intended to obtain information on the use of share incentive schemes for CAEs; the impact of the share scheme on the objectivity and independence of the CAE, and the oversight role of the CAC. The literature review also considered the context within which the CAE operates by taking cognisance of the governance recommendations in the King reports (especially *King III*), and the guidance available to internal auditors that has been issued by the Institute of Internal Auditors (IIA).

The role of internal auditors is encapsulated in the IIA's definition of internal auditing. The definition states that:

"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes" (IIA 2012a:4).

Given the requirement to 'add value' to the company, the use of share-based incentives can be as applicable to the CAE as it is to normal executives.

To achieve the aim of this article the study is broken down into the following research objectives:

- To explore the views of the CACs on the use of share incentive schemes for CAEs, taking into account the role and the position a CAE occupies in the company;
- To explore whether the CAE's participation in the company's share incentive schemes will influence his or her objectivity and/or independence; and
- To explore the oversight role of the Audit Committee regarding the share incentive schemes for CAEs.

This article addresses a gap in the literature on the use of share incentive schemes as part of the remuneration packages of CAEs in South Africa in that this study could not identify any existing literature that focuses on this topic. As the use of share incentive schemes for executive directors and senior executives is fairly widespread, it is likely that companies using these schemes will extend them to include the CAE. However, there is a risk that the inappropriate use of share incentive schemes could have a negative influence on the perceived independence and objectivity of the CAE, given that the internal audit function (IAF) is tasked with a key evaluation and assurance role.

Internal auditors are required by the IIA's *International Standards for the Professional Practice of Internal Auditing* (Standards) standard number 1100 to be independent and objective. (Standard 1100 requires specifically that "The internal audit **activity** (emphasis added) must be independent, and internal auditors must be objective in performing their work" (IIA 2012b, Standard 1100)).

This is interpreted in the Standards as follows:

"*Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the CAE has direct and unrestricted access to senior management and the board. This can be achieved through a dual-reporting relationship. Threats to independence must be managed at the individual auditor, engagement, functional, and organizational levels."* (IIA 2012b, Standard 1100.)

This interpretation is endorsed by Steward and Subramanian (2010:356), who point out that individual, and company-related issues like social pressure, economic interest and culture could impact on the CAE's independence and objectivity. Emphasising the value of different perceptions Glover, Prawitt and Wood (2008:209) note that external auditors hold the view that outsourced IAFs have a higher degree of independence than similar in-house functions. This view should be evaluated against the findings of the iKUTU research report (completed in 2008) to understand the demands and stature of internal auditing in large listed companies in South Africa. (The report was authored by eight academics that comprised the iKUTU team - Coetzee, Barac, Erasmus, Fourie, Motubatse, Plant, Steyn & Van Staden (2010:37)). The iKUTU report found that "the Big 4 external audit firms, excluding the company's own external auditors, are the major sources" of outsourced internal audit services (Coetzee *et al* 2010:37).

The reporting relationship, coupled with the professionalism of the internal auditor, can help reduce the risks or perceived risks that threaten the independence and objectivity of the CAE. The audit committee has an oversight responsibility over the work of the IAF, as recommended in *King III* (IoDSA 2009: principle 3.7). This oversight responsibility extends the role of the audit committee to also consider the impact of the performance and remuneration on the CAE.

In order to address these issues, the article is structured as follows: the literature review is discussed in section 2, giving an overview of incentive schemes – and specifically share incentives – within the context of the professional environment applicable to the CAE. Section 3 explains the research methodology used to achieve the aim and objectives of the article. In section 4 the results of the interviews are summarised, analysed and discussed. In conclusion, section 5 contains a summary of the major findings and highlights areas for future research.

2 LITERATURE REVIEW

The literature review discusses the origin of share incentive schemes and their evolution. It then considers how different personalities react to incentives, as well as the influence of motivational theories on the spread of share incentive schemes. The results of the literature review were used to develop the interview questions, which are listed in Annexure A, and offered in an effort to encourage more extensive research on the topic.

Sections 2.1 to 2.3 describe incentive schemes, including share incentive schemes. Thereafter, in section 2.4, share incentive schemes for the CAE are discussed within the context of the professional environment applicable to internal auditors.

2.1 Incentives

Kraizberg, Tziner and Weisberg (2002:384) identified four different incentives that are supposed to promote work motivation and performance. The four commonly used types of incentive scheme used by companies are:

> "*Merit pay* – when the employees are rewarded for exceeding the predetermined levels of performance. The targets that are set for the employees are easily calculable to verify if they have been attained.
>
> *Profit sharing* – this can be a portion of the organisation's profit, or a predetermined amount, that is distributed to the employees.
>
> *Gain sharing* – this can be a predetermined amount that must be saved by the company in costs over a specified period. The gains, when achieved, are shared with all employees.
>
> *Share options* – this is when the employee is offered the chance to purchase the company's shares at a predetermined future date and at a fixed price once the options are issued" (Kraizberg *et al* 2002:384).

The selection of a specific incentive scheme can depend on the objectives of the company, as well as on the assumptions in the motivational theory used to incentivise employees. Kraizberg *et al* (2002:384) link motivational incentives that encourage increased work efficiency to two management theories, namely the expectancy theory and the equity theory.

Lunenburg (2011:1) notes that the "expectancy theory is a cognitive process theory of motivation that is based on the idea that people believe there are relationships between the effort they put forth at work, the performance they achieve from that effort, and the rewards they receive from their effort and performance". Thus, the expectancy theory suggests people are motivated by their conscious expectations of what will happen if they behave in a certain way or do certain things. Pappas and Flaherty (2006) describe expectancy theory as remuneration that is linked to motivation, and say that the rewards must be aligned to the individuals' values. Merit pay, profit-sharing and gain-sharing support to a varying degree the concept that there is a link between behaviour and expected rewards, and can be used as mechanisms to motivate employees in the context of the expectancy theory. Share incentive schemes, in terms of the expectancy theory, generate lower levels of motivation and performance. This is because company performance is dependent, to a degree, on market forces which are outside the control of the individual employee. Kraizberg *et al* (2002:386) note that share incentive schemes are for those managers who are incentivised by a sense of ownership. This is also in line with the equity theory, which is about fair remuneration of employees based on their individual values. According to Bell and Martin (2012:111), equity theory is about employees believing that they are treated equally and fairly, and that management objectively treats those who are in the same position in the same way.

Over and above the motivational theories, the personalities of the individuals involved can also play a role. Furnham (2003:326) cites Gray's theory, which states that people who are extroverts respond very positively to rewards while introverts react when there is a threat or implied punishment (Furnham is alluding here to the challenges implicit in the use of a standardised incentive scheme).

The use of incentives is important: Wowak and Hambrick (2010:818) found that executives' personality characteristics and incentives do affect the company's results. Share incentive schemes are by their nature more suitable for employees who have overall responsibility for the wellbeing of the company, because they are in the best position to increase the value of the company as they enter into an arm's-length contract with the board (Bebchuk & Fried 2005:11). Company executives could include the (CEO), chief operational officer (COO), chief financial officer (CFO), chief information officer (CIO) and business unit heads. The chief risk Officer (CRO) and CAE can also be included in this list, as they are responsible for managing the risk and assessing the adequacy of the risk, control and governance processes respectively.

These executives usually have short-, medium- and long-term objectives that are aligned to the company's objectives. Share incentive schemes are a method of remuneration that can be used as an incentive to ensure the personal goals of these executives remain aligned with the company's objectives, thus ensuring that value is added to the company.

2.2 Share incentives

Barclays (in the UK), and Shoprite (in South Africa) are two of the relatively few listed companies that have received bad publicity in the past regarding their share incentive schemes (Treanor 2014; Carte 2011). This criticism highlights the risk that share incentive schemes can be considered too generous. Jensen, Murphy and Wruck (2004:57), who are also critics of share-based incentive schemes, are of the view that these yield excessive levels of compensation for the executives. These high levels of compensation can be likened to value destruction. The reason for the negative view of share incentive schemes is that the executives are not required to buy the shares or reduce their pay package/bonuses to be able to purchase the stock (Holden 2005:142). Therefore the executives could see the share allocation simply as (usually deferred) additional remuneration which tends to reduce their alignment to the company's objectives.

Another example of the risk posed by excessive share-based remuneration is demonstrated by the Enron affair. Healy and Palepu (2003:4) explain that Enron used an aggressive recruitment strategy with generous offers of money and shares as the main motivation for employees; this strategy focused on short-term goals. In 2000 and 2001 the Chairman and CEO of Enron were awarded compensation as shown in Table 1:

Table 1: Compensation paid to the Chairman and CEO of Enron

	Total compensation	Salary	Bonuses	Restricted stocks	Stock options	Other benefits
Chairman	\$18.2 m	\$1.3 m	\$7 m	\$7.5 m	\$0.8 m	\$0.38 m
CEO	\$10.9 m	\$0.85 m	\$5.6 m	\$3.5 m	\$0.87 m	\$0.05 m

Source: Healey & Palepu (2003)

Although it is good to take into account motivational theories and the personality profiles and preferences of individuals when developing incentive schemes, it might nevertheless be impractical for companies to effectively implement employee-specific incentive schemes. In addition, customised schemes could be demotivating when employees are motivated by the equity theory. Incentives, as part of the remuneration for employees and managers, are generally determined by the company and are therefore generic to the position, rather than specific to the person. The remuneration policy and practices fall under the oversight of the remuneration committee (REMCO), a board committee. *King III* recommends that the "remuneration committee should assist the board in its responsibility for setting and administering remuneration policies in the company's long-term interests for all levels in the company, but should be especially concerned with the remuneration of senior executives" (IoDSA 2009: principle 2.25). Similarly, it would be difficult for a company to approve an executive share-incentive scheme that would exclude some executives like the CAE – based simply on the assurance role fulfilled by the internal auditors – without a compelling professional reason, such as managing a threat to the independence and objectivity of the CAE. However, as internal auditors are professional people who are guided by a code of ethics, their professionalism should counteract threats to their objectivity, and the reporting relationship with the audit committee adds a further level of safeguards to protect their independence.

In the next sections the value of and risks applicable to share incentive schemes in general are highlighted, as these could also identify potential adverse impacts on the company should share incentive schemes be used to incentivise the CAE.

2.3 The value of and risks posed by share incentive schemes

According to Holden (2005:135) the original share incentive schemes were introduced by Du Pont and General Motors. These early share incentive plans gave the company's management exposure to risks and rewards in a way that was similar to that of shareholders, and were more long-term in nature (between seven to 10 years). The companies lent the managers money to buy the shares at market price and interest was charged on the loan amount granted (Holden 2005:135).

The characteristics of the Du Pont and General Motors schemes were as follows:

- The schemes provided the executives with participation in equity incentives that offered them risks and reward.
- The bonuses received by managers were partially used to pay off the debt.
- The dividends were received through the trust as a way of paying the debt (Holden 2005:138).

Holden (2005:142) criticises current share-based incentives because exposure to the risk part of the equation has been removed and the focus is now only on the reward for the company's executives. Lehmann and Hoffman (2010:71) mention that the banking and insurance crisis was a result of inadequate risk management processes. There was no proper accounting for the risk underlying the transactions. The current share incentive schemes make the executives focus on short term share price increases, without taking the company's overall and long-term performance into account. This could result in value destruction, due to short-term performance being achieved to the detriment of the long-term sustainability and business objectives. This view is supported by Smith and Nel (2010:12), who argue that the current executive incentive structures are geared to reward short-term risk-taking. There seems to be no assessment of these decisions in the long term to ensure that the company value is being maintained. *King III* (IoDSA 2009) contains principle 2.25 which focuses on fair and responsible compensation that is meant to enhance the shareholder value in the short, medium and long term.

Shortcomings of the current schemes can be summarised as follows:

- The scheme rules prescribe that the options are not worth anything until they exceed the exercise price. In these instances management is encouraged to take excessive risks to ensure that the shares appreciate (Hall and Knox 2004:403).
- The dividend policy that is adopted by management can encourage over-retention of earnings, as the holders of share options do not qualify to receive dividends (Hall and Murphy 2003:20).
- When the share options' actual price falls below the exercise price the options are either cancelled or reset. This means that the manager's specific share options are worthless and in many cases they are replaced by a new allocation (Holden 2005:142).
- The current share options' vesting periods are shorter and therefore management ends up focusing on the short-term rather than on the long-term performance of the shares (Holden 2005: 142).
- It is sometimes difficult for some senior management to accept share incentive schemes instead of bonuses, as they believe that they only have responsibility for and control over specific and narrowly defined areas in the organisation (Holden 2005:142).
- The critics of share incentive schemes believe that this type of incentive has been implemented as an additional benefit for executives. The share options are in most instances granted to the executives without them being required to pay fair value for the shares being awarded (Holden 2005:142).

Share incentive schemes for executives are most powerful in periods of rising market conditions. In addition, the schemes are open to the criticism that executives are being granted short-term share incentives without having to put up any personal finance. These situations can result in management focusing on short-term gains to the detriment of the medium- to long-term objectives of the company, simply in order to achieve the personal benefits arising from short-term share incentives (Holden 2005:142.).

Bhengu and Bussin (2012:90) conducted a study that indicated that share options are regarded as an important reward mechanism and part of talent management. However, the results of the survey also indicated that employees prefer rewards that are linked to individual performance (Bhengu & Bussin 2012:90). This is in line with the findings of Blair and Beer (2006:19) that share-based incentive schemes should address staff retention and must have performance hurdles.

To address the risks of an inappropriate incentive there should be an executive management remuneration policy that covers the incentives, including participation in share incentive schemes, and this should detail the criteria for participation and the objectives that must be met in order to earn and redeem the shares.

2.4 Share incentives for internal audit

According to PricewaterhouseCoopers (PwC 2010:8) the CAE needs to possess a strategic understanding that is employed to protect the business and to deliver value to the key stakeholders such as management and the audit committee. Given the requirement in the IIA's definition of internal auditing, that the function adds value, this strategic understanding can be the key to ensuring that the IAF fulfils the mandate set by the definition. In addition to the requirements set out in the definition of internal auditing, the members of the Institute of Internal Auditors (IIA), as professionals, are required to abide by the requirements of the Institute's code of ethics and its published Standards.

The specific responsibilities for the IAF, as recommended in *King III*, have raised the profile of the internal audit profession (IoDSA 2009: principles 7.1, 7.2 & 7.3). The question should therefore be asked: will share incentive schemes negatively impact the perceived professionalism of the CAEs? According to Denis, Hanouna and Sarin (2006:486), share incentive schemes can encourage people to participate in fraudulent activities if there is no oversight by the board.

The IIA's Standard 1110 guides internal auditors with regard to their independence and objectivity, stating that internal auditors must report potential situations that could impair their independence and objectivity (IIA 2012b). According to the IIA's Incentive Pay Survey (IIA 2004), there are disadvantages to participating in share-based incentives that are based on company performance. A few respondents to this survey believed this could impair the objectivity of the internal auditor and furthermore, damage the perceived independence of the IAF (IIA 2004). According to Holt (2012:891) there was a perception by investors that the trustworthiness of the disclosure was improved when the CAE reported to the audit committee functionally, and to the CEO administratively. IAFs that report to the CFO were perceived to be less independent and therefore more easily influenced by management (Holt 2012:891). Dickins and O'Reilly (2009:19) performed a study investigating the independence of the IAF which focused on the correlation between CAE reporting lines and annual remuneration reviews. The study revealed that only 51% of the CAEs' had a primary reporting line to the audit committee, while 31% reported primarily to the CFO, and 12% reported to the CEO (Dickins & O'Reilly 2009:19). The research demonstrated a link between perceived independence and the reporting lines of the IAF.

Dezoort, Houston and Reisch (2000:45) conducted a survey that found that 23% of the internal auditors surveyed received share incentives or a combination of cash and shares as incentives. The internal audit department in most instances is subject to the same compensation plans as other employees in the company. The respondents also believed that internal audit productivity and effectiveness increases when they participate in incentive-based compensation (Dezoort, Houston & Reisch 2000:45). Hanafi and Steward (2015:48) confirmed during their recent study that internal auditors do receive incentive based compensation. The incentive based compensation should ideally be linked to the non-financial key performance indicators of the organisation, such as the internal audit department's value add and levels of its clients' satisfaction.

Schneider (2003:494) indicates that share incentives did not affect the internal auditors' reporting decisions, as internal auditors viewed shares as long-term incentives that did not impact their reporting. The Chartered Institute of Internal Auditors (CIIA 2013) supports the idea that the CAE's remuneration should be designed in a manner that prevents potential conflicts of interest. As it would be difficult for the CAE to influence the medium- to long-term performance of the company by consistently failing to report irregularities discovered during a risk-based internal audit, medium- to long-term share-based incentives should not have an adverse impact on the objectivity or independence of the CAE.

King III (IoDSA 2009: principle 2.25), in referring the determination of remuneration to REMCO, includes 'executives', which is wide enough a definition to include the CAEs. This would ensure that there is independent monitoring and approval of these types of share incentive schemes should they also be granted to the CAE. This can be further strengthened by adding claw-back provisions. A claw-back provision is a special contractual clause that is sometimes included in the employment contract that deals with benefits that can be taken back under specific circumstances. The Financial Reporting Council (2014) has revised the UK Corporate Governance Codes and has included a provision to include claw-backs on variable pay in the event of discovery of misstatements or misconduct. Claw-back provisions are something that the audit committee can consider for inclusion in the CAE's performance contract, thus ensuring that variable remuneration packages implement best practices. Deloitte (2014:3) is of the view that the audit committee needs to play a strategic review role and to benchmark the remuneration package applicable to the CAE.

The literature review considered the different incentives for employees, but with particular focus on executive share incentive schemes. This type of incentive has been criticised as it is perceived to focus on enhancing the short term performance of the company. The interviews and research quoted focused on the status of the IAF and the share incentive schemes for CAEs. This was undertaken to establish whether the CAE's participation in share incentive schemes could damage the perceived independence of the IAF and the objectivity of the CAE. More detail on the research methodology followed to achieve the aim of this study is presented in the next section.

3 RESEARCH METHODOLOGY

This article reports on the use of exploratory research conducted in a multiple case study framework, focusing on seven companies, as the individual case studies, to achieve the research objectives. Page and Meyer (2003:22) describe an exploratory study as an exploration of a problem. The study being reported here was limited to South African companies, as the seven companies selected are all listed on the main board of the Johannesburg Stock Exchange (JSE). Data was collected from the chairpersons of the audit committees using structured interviews. A qualitative methodology was followed, using a positivistic perspective to analyse the data from the interviews. A positivistic perspective is valuable in this case as it "assume[s] that reality is objectively given and can be described by measurable properties which are independent of the observer" (Myers 1997). Gordon (2011:6) indicates that qualitative research is about how an individual and/or groups reason on certain issues: in this instance the issue was the use of share incentive schemes as part of the remuneration of the CAE. It was seen as important to interview the chairpersons of the audit committees, as they are the most influential people in a company's audit universe, given their oversight role over the internal audit function and the CAE. The company's board delegates governance responsibilities to the audit committee under the leadership of the chairperson. Turney and Zaman (2007:25) indicate in their research that audit committees have a significant influence over management and the various assurance providers, including the IAF. The audit committee members and the culture of the company could therefore influence the governance process. Thus, audit committees that fulfil their governance responsibilities have a greater chance of ensuring that their companies implement and apply effective governance principles. The next sections provide more detail on the companies selected for study (section 3.1), and the data collection process (section 3.2).

3.1 Case study

The target population was large companies from multiple industries that are listed on the JSE. The companies selected were all listed on the main stock exchange at the time the interviews were conducted, and are perceived to be strong and influential companies in their sectors. Purposive sampling was used and considered the size of the companies, and the industries in which they operated, as well as whether the researchers could gain access to the CACs. The market capitalisation of the participating companies ranged from R440 billion to R3 billion, with a combined total market capitalisation of approximately R550 billion on 1 November 2014. For the purpose of confidentiality, the seven companies are presented anonymously as companies A to G.

3.2 Data collection

Data was collected from the participants (CACs & selected CAEs) using a structured interview template, designed to address issues identified in the literature review reported above. The questions were open-ended, in order to allow the participants maximum opportunity to express their views. Participants were also specifically asked if their company's policy with regard to the participation of the CAE in an incentivised share scheme differed from their own personal views.

The interviews with the CACs were recorded to ensure that important information was not omitted, lost or overlooked. In order to validate the information collected, the responses were transcribed and e-mailed to the interviewee for approval prior to the data analysis.

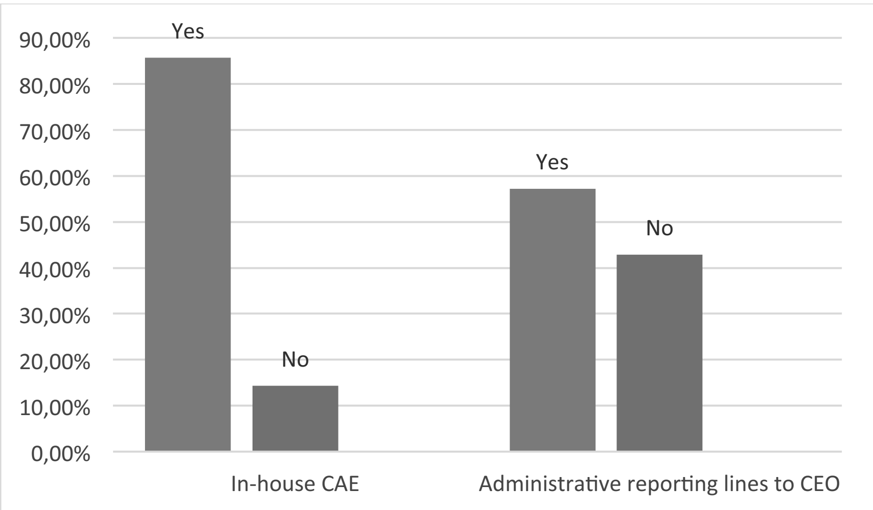
The interviews were conducted with six chairpersons of audit committees who represented the seven companies, as one person was chairperson for two companies. The questions were sent to the participants prior to the meetings to ensure that they would be adequately prepared for the interviews. Remuneration information was also gathered from the 2013 integrated annual reports of the participating companies and verified during the interviews.

4 RESULTS AND DISCUSSION

Of the seven companies, six had in-house CAEs who were participants in their companies' incentivised share schemes, while the seventh company made use of an outsourced provider for its internal audit services. The CAE of the outsourced IAF was deemed ineligible to participate in the company's share scheme. The profiles of the six participating CAEs showed that they had been, or were currently executives of their companies. All had obtained Chartered Accountant (South Africa) professional qualifications (CA(SA)). As CA(SA)s they are obliged to ensure that remuneration received as part of an incentive scheme is in line with the requirements of ET 102 section 340 (SAICA student Handbook 2014/2015 III). The average age of the CACs who were interviewed was 62 years. In addition, the average duration of their tenure as the chairpersons of their companies' boards' audit committees was 6.5 years, and ranged from two to 12 years. One of the six in-house CAEs did not participate in a share incentive scheme; nevertheless he/she was also interviewed to obtain his or her views on the use of share incentives. Similarly, the CAE of the outsourced IAF was interviewed to obtain his or her views on three of the research themes that relate to share incentives for an in-house CAE. The information gathered during the interviews was sub-divided into three main themes, as will be discussed in sections 4.1, 4.2 and 4.3 below.

4.1 Status of the IAF in the company

Figure 1: Status of the IAF in the company



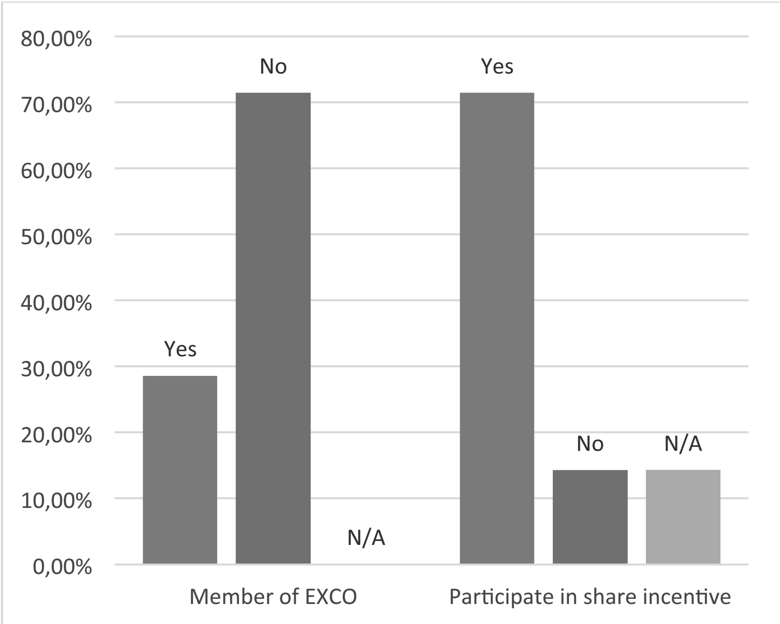
From the information in Figure 1 it is evident that 86% (n=6) of the companies have in-house IAFs headed by CAEs. One company outsourced its IAF to an internal audit service provider. The CAE's role was also fulfilled by the service provider. The iKUTU research report shows similarly limited use of outsourcing by large listed companies, recording that 86.6% used an in-house or co-sourced IAF (Coetzee *et al* 2010: 21). The company in this study that uses a fully outsourced IAF represented only 13.4% (n=1) of the functions surveyed.

Although this is not shown in Figure 1, all of the CAEs reported functionally to their company's CAC. The IAFs were thus compliant with Standard 1110 – organisational independence (IIA 2012b), and *King III's* recommended practice 7.4.4, which recommends that the function reports functionally to the audit committee (IoDSA 2009). Thus, the actual reporting lines used enable the CAE to operate within the independence parameters recommended by the IIA.

The administrative reporting lines were split almost equally: 57% (n=4) reported to the CEOs and 43% (n=3) to the CFOs of their respective companies. The three instances where the CAEs reported to the CFOs were justified by the CACs, the situation being considered suitable given the way these businesses were set up. These were divisions/entities that were supported by the central shared services, which included internal audit. The iKUTU research report identified more favourable functional reporting lines, in that 83% of the CAEs reporting functionally to the CAC (Coetzee *et al* 2010:19).

Standard 1110 – organisational independence – does not prescribe the operational reporting lines, but does say that the CAE *should* report to someone at a level that could assist the IAF to fulfil its responsibilities (IIA 2012b). It is therefore important for the independence of the IAF that it have a strong and effective functional reporting line to the CAC and an operational reporting line to the CEO or any other person approved by the audit committee. *King III* requires companies to 'apply or explain' how its principles and recommendations have been applied or not applied (IoDSA 2009:6).

Figure 2: Status of the IAF/CAE within the company



As shown in Figure 2, over 70% (n=5) of the CAEs were not formally part of their company's executive committees (EXCO). Membership of the EXCO was the prerogative of the CEO. The CACs indicated that the excluded CAEs did still participate, as invitees, called on from time to time to present audit items at EXCO meetings, and also attended other governance forums of their companies. There was consensus that sitting on EXCO is not only about the position one held within the company; as two CACs mentioned, the "CAE must have the right gravitas and attitude to be part of the executive team".

According to the CIIA (2013), the CAE should participate at EXCO level to give the person the appropriate standing within the company; so that she/he has ready access to decision-makers, and thus the proper authority to professionally challenge executive decisions when necessary. Although in this study only 30% (n=2) of the CAEs were members of EXCO, it is a practice that other companies should consider implementing. The CAE can be a permanent invitee of EXCO (thus entitled to contribute, but without the right to vote on operational issues), which would maintain the independence of the function and his or her objectivity, while still having formal and unhindered access to the company's executives.

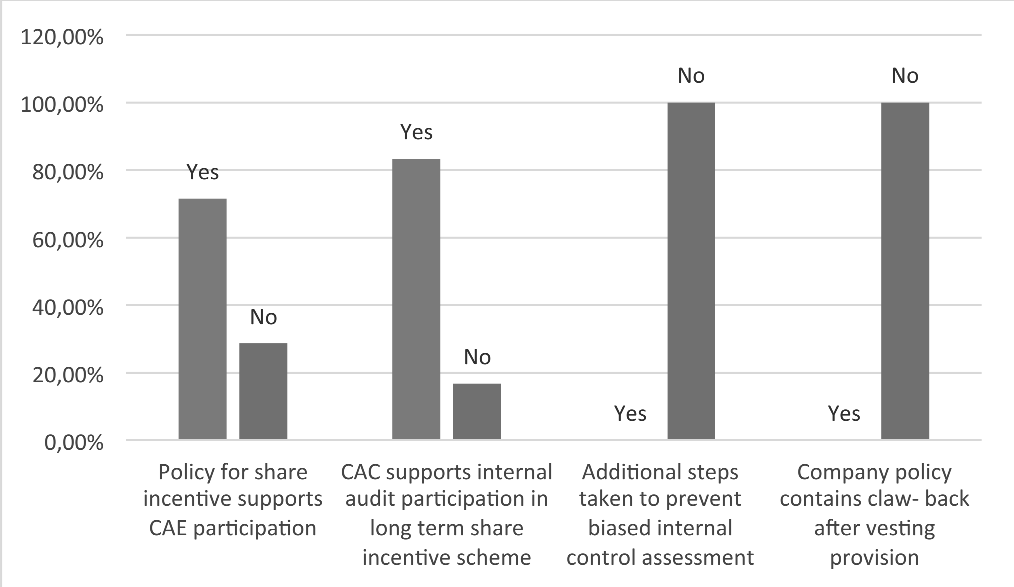
In addition, Figure 2 shows that 70% (n=5) of the CAEs participated in their companies' share incentive schemes. Only the company that has outsourced its IAF to an independent service provider does not use share incentives as part of CAE remuneration, as their fees are contractually fixed. According to the CAE of the outsourced IAF: "The staff is not allowed to buy shares of the client companies. This practice extends to the internal audit outsourced function. This is part of the professional business independence rules".

Outsourcing tends to mitigate the perceived risk to independence, as the CAE does not participate in client share incentive schemes. This comment is consistent with the findings of Glover, Prawitt and Wood (2008:209), whose research confirmed that external auditors are willing to rely on outsourced internal auditors because they perceive them to be more independent than an in-house function.

4.2 Company share incentive schemes and acceptance by the Audit Committee

As shown in Figure 3, participation by the CAE in share incentive schemes was permitted in terms of company policy for 70% (n=5) of the respondents, and prohibited for 30% (n=2). Figure 3 also shows that six CACs (representing about 83% (n=5) of the participants), did not believe that the participation of the CAEs in long-term share incentives could impair their objectivity, as long as the allocation was more heavily weighted towards individual and departmental contribution to company successes.

Figure 3: Company share incentive schemes and acceptance by the Audit Committee



Some of the views of the CACs who support CAE participation in share incentives are quoted below:

- "Participation of senior employees in share incentive schemes does aid the company in attracting and retaining senior employees";
- "It is important to want him or her to be part of the team – very important. If the individual is too "independent" it can cause lack of trust. The CAE should be treated as an executive based on the levels agreed by the company";
- "It is to the benefit of the company to include the CAE in the long-term share incentive if he or she is improving the control environment in the company", and
- "The CAE does not have decision-making authority and does not have control over the transactions processed by the company".

According to the CACs, internal audit is only one element of the control framework; they also rely on other assurance providers for internal control assessments. The external auditors and other assurance providers play a role in the validation of the internal financial control written statement that is attributed to the CAE, while proper governance structures and the board play an oversight role over the executives.

According to the CACs, failure by the CAEs to conduct their work in a professional manner could have a negative impact on their individual reputations, should the CAE be dismissed due to misconduct. A CAE who is dismissed from an IAF might subsequently struggle to find other professional employment.

Although the professional qualifications of the CAEs were not requested during this research, the iKUTU report revealed that 76% of CAEs of large listed companies are either Chartered Accountants (holding the (CA(SA) qualification) or Certified Internal Auditors (holding the CIA designation) (Coetzee *et al* 2010:20).

The views expressed against CAE participation in share incentive schemes revolved around the independence that could be impaired. As one of the CACs said: "this individual should be completely independent and should not hold shares in the company, similar to the external auditors*".*

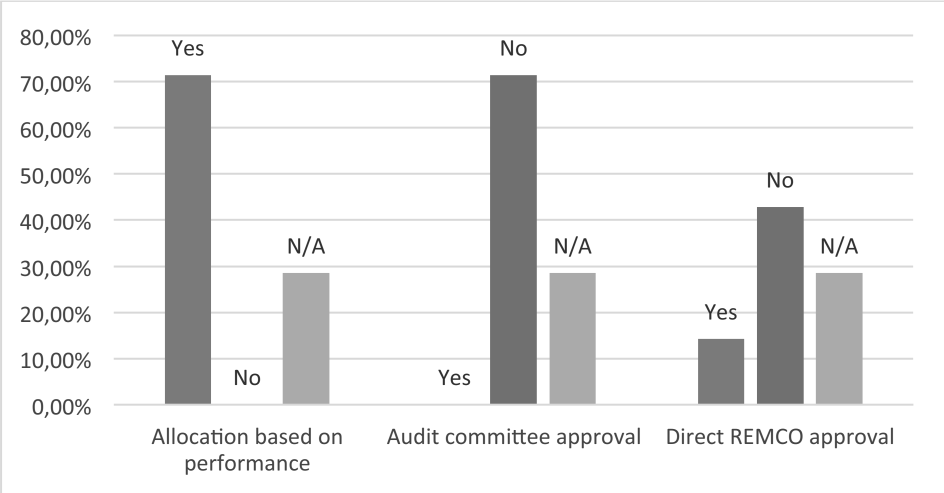
We can draw the conclusion from the above that for some interviewees, internal auditors should be treated similarly to independent non-executive directors of companies, or external auditors. The CAE must therefore not have connections that may lead to any kind of conflict of interest in the future. The view against participating in share incentive schemes was unexpected. It can be argued that the dissenting CAC demands an exceptionally high level of independence from his/her IAF. The views of this CAC could also have been informed by his/her external audit background and the recommendations in this regard from the UK's financial services sector, with which he/she is familiar. (The CIIA (2013:9) recommends that CAE remuneration be structured in such a way as to avoid conflict of interest.)

According to the CACs, none of the companies' long-term share incentive schemes have claw-back clauses. The possibility of having claw-backs is something that can be implemented in the company's remuneration policy, with specific criteria for claw-backs being defined for participating CAEs by the audit and remuneration committees, as this would mitigate many of the concerns of possible conflict of interest.

4.3 Monitoring of the CAE share incentive

Figure 4 illustrates that 70% (n=5) of the CAEs believe that individual or departmental performance plays a big role in the allocation of their long-term share incentives. The performance assessments of the CAEs were undertaken by management with additional, informal input being requested from the audit committee. The CACs do not get to review or approve the share incentive scheme allocations to the CAE either for appropriateness or fairness. This is an area that could be improved by having the audit committee review the remuneration structure and results of the performance management assessment of the CAE annually.

Figure 4: Monitoring of the CAE share incentive



In Figure 4 only one CAE's remuneration was referred to REMCO for review based on this specific sub-committee's mandate. In the other instances the CEO or CFO would allocate shares and bonuses to the CAE and other senior employees based on the guidelines provided by REMCO.

Figure 5: Number of years before full vesting

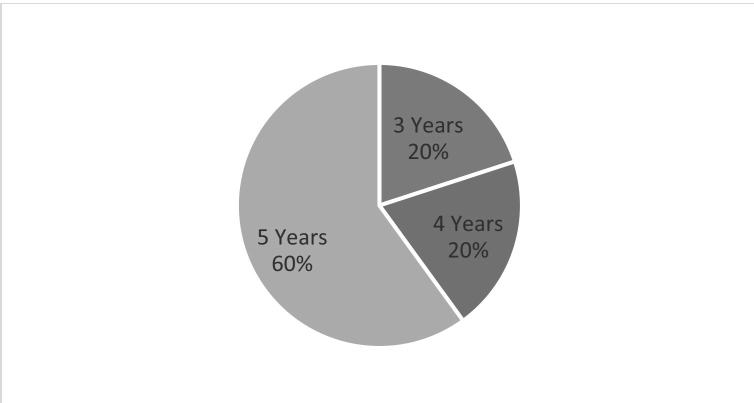


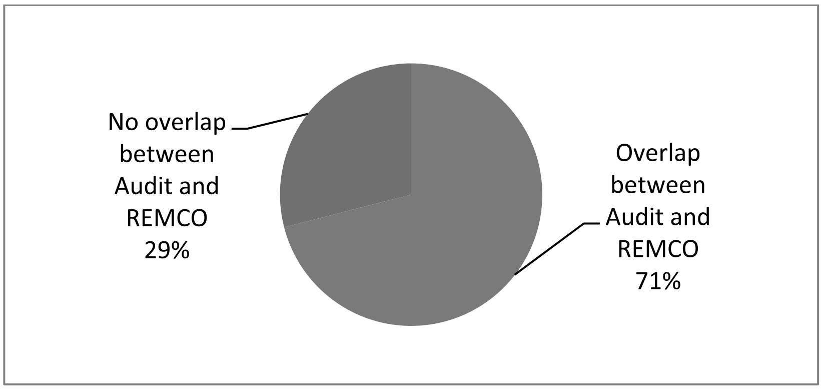
Figure 5 illustrates the vesting policies of the five companies whose CAEs participate in the companies' share incentive schemes. One company (n=1 (20%)) had a full vesting of shares after three years, and another had full vesting after four years (n=1). The other three companies (60%) have full vesting after five years. The tranches set out in Table 2 explain the delayed vesting periods, and are used to ensure that high-quality performance continues in the medium term.

Table 2: Share vesting periods

Company	No. of years before vesting	Tranches percentage vesting
A	2 to 5	20% in year 2, 20% in year 3, 30% in years 4 and 5.
B	3 to 5	Shares can fully vest anytime between 3 and 5 years.
C	3	Shares vests in full by end of year 3.
D	3 to 5	33.3 % in year 3, year 4 and year 5.
E	3 to 4	50% in third year and 50% in fourth year.

The schemes above can be seen as medium-term incentive schemes, as the shortest vesting period is two years after issue of the shares (company A). The other three companies' share incentives begin vesting in tranches from year 3 (as indicated in Table 2), and full vesting is attained between three and five years from issue. It is possible for the CAE (or any executive for that matter) to hide wrongdoing from the audit committee and thereby gain financially in the short term; however, it would be very much more difficult to hide errors/wrongdoing for a longer period. Thus, the use of longer vesting periods would appear to address some of the objections raised to the use of short–term share incentive schemes as a remuneration mechanism.

Figure 6: Cross-membership between committees



The cross-membership between the audit committee and REMCO was assessed in the participating companies. As illustrated in Figure 6, in 71% (n=5) of the companies there is overlapping membership between the audit and remuneration committees. This could be seen as a best practice in that it should ensure that audit-related issues are given prominence at REMCO and vice versa. Chandar, Chang and Zheng (2012:161) found that it was beneficial for the company to have overlapping memberships between the audit and remuneration committees. The CACs who are also members of REMCO are thus better able to assess the fairness of the overall remuneration of the CAE. Furthermore, the IoDSA (2009: principle 3.7) gives the audit committee the responsibility of ensuring the performance assessments and possible dismissal of the CAE are conducted fairly.

5 CONCLUSION AND RECOMMENDATIONS

The CAE plays an important role in evaluating and assuring the adequacy and effectiveness of the risk, control and governance processes of the company in order to add value to the company. The study found that most of the CACs did not believe that participation in their companies' share incentive schemes would influence the assurance opinion that is received from the CAEs. This is because the reporting lines help to ensure the independence of the CAE, and the professional requirements subscribed to by the CAEs, linked to the reputational risk posed by non-professional conduct, protect the CAE's objectivity. In addition, the use of combined assurance, where other assurance providers table reports on common events and processes help the audit committee to validate the findings of the IAF.

There is consensus amongst the majority of the CACs that the participation of the CAE in medium- to long-term share incentive schemes can be good for the company as well as for the individual CAE.

The participating companies had medium-term share incentive schemes that fully vest after a minimum of three years, or in tranches extending from 20% in year 2 until completion in year 5. Where tranches vest a minimum three years from allocation, this can positively contribute to the CAE's long-term outlook and value creation.

The audit committee was found to have a weak oversight role over CAE remuneration. The CAEs' performance management and remuneration was handled by the CEO or CFO, because it was understood to be an administrative responsibility. The CACs did not formally approve the remuneration of the CAEs despite this being required by the *King III* principles. Despite the IoDSA (2009: principle 3.7) identifying the audit committee as being responsible for the appointment, performance assessment and dismissal of the CAE, this might be a function that could still be practically difficult for the audit committee to perform. Future research could be done to assess whether the audit committees are practically able to fulfil the responsibilities of appointing, conducting performance assessments and dismissing the CAEs. The monitoring mechanism of the CAE's performance and remuneration can be improved either by having the role referred to REMCO, or by requiring the audit committee to formally approve the CAE's remuneration as one of the audit committee's year-end duties.

This article has certain limitations. The population comprised only seven JSE-listed companies, drawn from multiple business sectors. In addition, only the chairpersons of the audit committees were interviewed, and unlisted companies and public sector entities were excluded from the study. Therefore, the results cannot automatically be assumed to apply to all (or even any) other companies. Despite these limitations, the research uncovered well-articulated perceptions about the impact of share incentive schemes on the independence and objectivity of the CAEs. It is therefore recommended that future research be expanded to study more listed companies, and/or unlisted and public-sector organisations, assessing the roles of audit committees in the implementation of the *King III* principles in regard to the appointment, performance assessment, incentivising and dismissal of the CAEs.

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ANNEXURE A

The questions that were posed to the CAC were as follows:

- What is the standing of the internal audit department in the organisation (mandate, reporting lines, stature of the IAF within the Group)
- How is the CAE's salary structured in terms incentives, this is in comparison with other Executives at the same level? (this refers to the employee grade)
- Does the CAE participate in share based incentives (short or long term incentives)?
- If no, what are the alternative incentives structures that are implemented to ensure that the key audit staff members are retained by the organisation?
- How does the audit committee ensure that the CAE does not unduly benefit from short term increase in share price that is achieved at the expense of long term value destruction?
- In the year that the shares vest, does the Audit committee implement additional steps to ensure that the CAE does not become bias in his/her assessment of internal financial controls?
- Does the company have policy that supports the participation of the CAE in the company share incentive scheme?
- In the event of wrongdoing being established against the CAE after the shares have vested. Are there claw backs clauses in the contract or policy?
- Do you believe it will be beneficial if the remuneration of the CAE is referred to Remuneration Committee for approval?

Stakeholder perceptions on the role of internal audit in risk management: A mining industry perspective

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ABSTRACT

Organisations are faced with risks that can hinder them from meeting their objectives: these risks are both expected and unexpected and could include 'black swans'. The internal audit function assists management by providing assurance regarding the effectiveness of its risk management processes. By applying a risk-based audit approach internal auditors could enhance the risk management process. However, the literature indicates that the internal audit function may not be playing the role in risk management that its stakeholders require. Interviews were conducted with four groups of stakeholders in the risk management process in the mining industry to identify the expected role of internal audit. The research found that internal audit was performing in line with expectations, but must in future play a bigger role in determining the organisation's strategic direction by challenging risk identification and assumptions, thereby promoting sustainability. This requires enhancing their technical skills in understanding operational risks specific to mining.

Key words

Internal audit; risk management assurance; risk-based auditing; risk-based audit plan; mining sector; 'Black Swan'

1 INTRODUCTION

The 'black swan' theory, as described by Taleb (2007), refers to the occurrence of an unexpected (to the observer) event, which has a major impact and consequent effects, which is often inappropriately rationalised with the benefit of hindsight. The theory tries to explain the disproportionately important role of high-profile, hard-to-predict and rare events that are beyond the realm of normal expectations (Aven 2013). A perfect example of a 'black swan' event is the recent Marikana tragedy that occurred in the South African platinum mining industry. The company involved had a valid and long-standing labour agreement with one of the unions at the mine, and therefore did not expect the majority of their workforce to take part in illegal and protracted strike action, nor did they anticipate the deaths of 44 people and the prolonged labour unrest across the country's mining sector (Botiveau 2014; Ledwaba 2013). Had industrial and labour relation risks been properly managed and the procedures more effectively reviewed and monitored, the potential risk impact of an emerging labour union could have been taken into account, and these unfortunate effects could perhaps have been avoided or at least muted. Such actions relate to the concept of risk management, a process of identifying, assessing, managing and controlling situations that may inhibit an organisation's efforts to meet its objectives (Coetzee 2010:33).

Although the responsibility for risk management lies with the board and senior management of organisations (COSO 2004; IIA 2014b; IoDSA 2009), the internal audit function (IAF) is in an ideal position to assist with this task (Coetzee 2010:233; IIA 2009). This view is supported by the significant changes and improvements to, and adaptions undergone by the internal audit profession since the founding of the Institute of Internal Auditors (IIA) in 1941 (Dawuda 2010:11-15; IIA 2014a; Salehi 2012:82; Swinkels 2012:13-15) and the widespread introduction of corporate governance regulations (ASX 2014; FRC 2012; IoDSA 2009). At the same time, the field of risk management has also grown at a rapid pace, assisting businesses to manage their risks (Arena, Arnaboldi & Azzone 2010:659; Dionne 2013; Hoyt & Liebenberg 2011:798; Wu & Olson 2010:837), through the development of a set of risk management frameworks (COSO 2004; ISO 2009).

The role of the IAF in risk management has enjoyed widespread debate in academic literature (Coetzee & Lubbe 2011:55; De Zwaan, Stewart & Subramaniam 2011; Karagiorgos, Drogalas, Eleftheriadis & Christodoulou 2009; Sarens & De Beelde 2006; Ţurlea & Ştefănescu 2009:213; Vinnari & Skærbæk 2014). Studies have shown that IAFs are becoming more aware of their responsibilities in the risk management field (Coetzee & Lubbe 2011:43-44), but that they have not yet fully embraced these responsibilities (De Zwaan *et al* 2011; Karagiorgos *et al* 2009; Sarens & De Beelde 2006; Ţurlea & Ştefănescu 2009:213; Vinnari & Skærbæk 2014). It appears that they are still only reviewing particular risks (such as financial risks), and not the whole risk management process (Allegrini & D'Onza 2003:191; Allegrini, Giuseppe, Melville, Sarens & Selim 2010: xvi). Furthermore the literature shows that although a risk-based audit approach is supported by internal auditors, and that they have the intention to implement such an approach, in many instances this has not yet occurred (Allegrini & D'Onza 2003:197; Coetzee & Lubbe 2011:50; Coetzee & Lubbe 2013:132-133).

The IIA has indicated that the IAF has a very valuable role to play in both the assessment of risk management and in the use of risk management results for planning purposes (IIA 2013:9). It is therefore surprising to note that in the 2010 Common Body of Knowledge (CBOK) studies conducted by the IIA, an average of only 58.2% of internal auditors rated risk management as an important knowledge area in which an internal auditor should be proficient (Bailey 2010:55). Other studies have also identified shortcomings in the involvement of internal auditing in risk management: for example, Fernández-Laviada (2007:144) found that for those banks participating in the study, their IAFs had not performed a review of the operational risks despite their being required by legislation, and Leech (2013:1) stated that internal audit continues to employ traditional audit approaches and is not truly focusing on implementing a risk-based approach.

Based on the above, there appears to be a gap between what is expected of internal auditors by their profession, the regulations and their own management's requirements in relation to what is being done in practice when it comes to risk management. This identifies a need for further studies exploring the perceptions of audit committee members, management and other stakeholders regarding internal audit's role in risk management (De Zwaan *et al* 2011:600-601). These form the focus of this paper, which contextualises and presents the findings of a study performed to determine the role of internal audit in managing the risks faced by mining companies (mining is the South African economic sector that has recently been most seriously challenged to fundamentally rethink risk management (PwC 2013:2)).

The findings of this study show that all the participants believed that the assurance given regarding the risk management processes, as well as the risk-based approach that the IAFs are following in their organisations, align with their expectations of the roles that their IAFs should play. However, several areas were noted where these roles could be improved; in particular, the fact that a more strategic role with regard to challenging conventional risk identification and risk assumptions should occur within the IAF, as they have the broadest perspective of all the departments and role players within the organisations. This was supported by the requirement that more focus should be placed on the sustainability of the organisation and the risks that this challenge holds. The study indicates the need for internal auditors to obtain relevant technical skills so that they are better equipped to evaluate some of the more technical and operations-based risks unique to the mining industry.

2 OBJECTIVE OF THE STUDY

The IIA's *Standards for the Professional Practice of Internal Auditing* (Standards), together with legislation and regulations, require an IAF to create a risk-based internal audit plan in order to provide assurance over the effectiveness of internal controls, risk management and governance processes (COSO 2004:6; IIA 2013:6; IoDSA 2009:69; ISO 2009:20; RSA 2010:61). Depending on directives from management, the board and the audit committee, internal auditors can play a variety of consulting, assurance and advisory roles in an organisation's risk management process (IIA 2009:3-6). The literature does however provide evidence that practices do occasionally differ from theory (Bailey 2010:55; Fernández-Laviada 2007:144; Leech 2013:1).

The objective of this research is to investigate the role of internal audit in risk management in the mining sector. Both perspectives (the internal auditor's role in managing an organisation's risk and the need for a risk-based internal audit coverage plan), are considered by identifying stakeholders' perceptions. The research is, however, limited to three case studies, consisting of three multinational organisations in the South African mining sector. The reasoning is explained in the Research Methodology section.

This study will benefit all practising internal auditors, risk managers (RMs) and other stakeholders (including the IIA and mining companies), by giving dimension to the gap noted between the required role of internal audit in risk management and the actual role that they are playing, and by highlighting possible reasons for the gap. This study could provide information upon which future guidance from the IIA could be based. Furthermore, IAFs in the mining sector can compare their own risk management activities with the findings presented in this study, thus enabling them to cast light on areas for improvement that are in line with expectations expressed in the literature.

The structure of the paper is as follows. Firstly, to contextualise the research, a literature review is presented, showing that internal audit is well positioned to play various roles in the risk management process and to follow a risk-based audit plan. This is followed by a description and explanation of the research method. The results are then discussed and the final section draws a conclusion and presents suggestions for future research.

3 REVIEW OF CURRENT LITERATURE

3.1 Key role players in risk management

The concept of risk has become central to corporate governance and is therefore linked with internal controls within an organisation (Cohen, Krishnamoorthy

& Wright 2010:751; Radu 2012:128; Spira & Page 2003:64; Vinnari & Skærbæk 2014:492). With the recent failures in the global markets much emphasis has now been placed on corporate governance regulations, including the responsibility of the board to provide assurance that risk management processes have been implemented in the business (Cohen, Krishnamoorthy & Wright 2010:751; Radu 2012:128; Spira & Page 2003:64; Vinnari & Skærbæk 2014: 492). These regulations include *The King Report on Governance for South Africa, 2009* (King III) (IoDSA 2009).

The responsibility for risk management rests solely with the board of directors of the organisation; however, they can delegate the performance of some of these roles to management or to an audit committee to assist them (ASX 2014:28; FRC 2012:18; IoDSA 2009:54-81). Corporate governance regulations provide guidance, identifying the key role players within the risk management field (IoDSA 2009; FRC 2012; ASX 2014). One such key role player is the risk management department (RMD), which can represent management when it reviews, identifies and assesses risks within the organisation (Burnaby & Hass 2009:540; COSO 2004:6; IoDSA 2009:22; ISO 2009:22). The role of the RMD can be further expanded to include discussing the organisation's risk management appetite (creating awareness within the organisation) (Burnaby & Hass 2009:541; COSO 2009:5); understanding risks at a strategic level (Burnaby & Hass 2009:541; COSO 2009:5); reviewing the portfolio of risks (COSO 2009:5); being aware of the most significant risks and their organisation's responses (Burnaby & Hass 2009:541; COSO 2009:5); and monitoring and reporting on the risk management process (Burnaby & Hass 2009:541). The other key role player in the risk management field is the IAF, which can fulfil supporting and independent roles through advising, assuring and monitoring the risk management process, as well as making use of risk management practices within their own fields of expertise (COSO 2004:6; IoDSA 2009:69; ISO 2009:20; RSA 2010:61).

The roles that are therefore played by the RMD (Burnaby & Hass 2009:540; COSO 2004:6; IoDSA 2009:22; ISO 2009:22) and IAF (COSO 2004:6; IoDSA 2009:69; IOS 2009:20; RSA 2010:61) are complementary in nature, while maintaining different perspectives (Manab, Hussin & Kassim 2013:65). The RMD is ultimately responsible for the implementation and operation of the risk management programme, while the IAF is responsible for monitoring and providing assurance on the effectiveness of the risk management process, thus fulfilling a control function (Manab *et al* 2013:64). It can therefore safely be assumed that a well-balanced and effective communication and knowledge-sharing line is a prerequisite between the two functions as they are required to work closely together.

3.2 Role of internal audit in risk management assurance

The IIA has developed guidelines outlining the roles and accountabilities of an IAF in relation to risk management (IIA 2009). These roles and accountabilities have been split between core roles for the IAF, legitimate roles that can be assumed (subject to the institution of appropriate safeguards), and roles that should not be undertaken by the IAF (IIA 2009:4). The latter (roles to avoid) include setting the risk appetite, performing management's functions with respect to risk management, and assuming accountability for risk management (IIA 2009:4). The core activities include giving assurance as to the effectiveness of the risk management process, ensuring risks are correctly evaluated and responses are both appropriately designed and effectively implemented (IIA 2009:4), and supporting the overall process (Allegrini & D'Onza 2003:196). Roles that may be assumed (subject to taking appropriate precautions), include consolidated reporting to the audit committee on the results of the risk management process (Allegrini & D'Onza 2003:196; IIA 2009:4); coordinating risk activities; developing risk strategies (Arena *et al* 2010:782; IIA 2009:4); and contributing to the improvement of an organisation's risk management framework (Coetzee 2010:35).

A major risk event, or 'black swan', does not result from the materialisation of a single risk, but usually from a series of seemingly minor wrong decisions and risks that were not managed properly (Lam 2009:25). A possible counter-strategy is the establishment of an Enterprise Risk Management (ERM) process, which is still a very fluid term with various interpretations in different organisations (Arena *et al* 2010:659). However, ultimately ERM, in which the IAF could perform a coordinating role, involves the escalation of risk management to a more strategic level that encompasses the whole of the organisation, in order to ensure that reasonable assurance can be given that an organisation will achieve its goals, through the identification, assessment and effective management of risks (Arena *et al* 2010:659; Hoyt & Liebenberg 2011:798; Golshan & Rasid 2012:277; Paape & Speklé 2012:1).

For this reason the Committee for Sponsoring Organisations (COSO) developed a framework for risk management in 2004 (COSO 2004). Several additional documents have subsequently been published, all intended to reinforce the original principles of the 2004 framework. These include *Strengthening enterprise risk management for strategic advantage* (COSO 2009) – which emphasises the fundamentals contained in and use of the 2004 framework (COSO 2009:4–18), and the 2013 *COSO Framework and SOX Compliance* (COSO 2013) – which requires the use of the 2004 framework when performing risk management (COSO 2013:7). The COSO framework consists of eight elements perhaps the most important of which is (from an internal audit perspective), the monitoring element, which requires that the risk management process should be regularly reviewed (COSO 2004:4). The framework itself also sets clear roles and guidelines for the IAF, confirming that they have key responsibilities and roles to play within the risk management field (COSO 2004:6). These roles and responsibilities include considering the breadth of their focus on ERM (COSO 2004:7), providing input to the board where requested (COSO 2004:6-7), and monitoring the effectiveness of the risk management process and suggesting improvements where required (COSO 2004:4). It appears that the COSO framework is being applied in practice, because it was noted that 67% of internal auditors interviewed in Italian companies have adopted the COSO framework for testing and monitoring purposes, albeit for mainly operational audits (Allegrini & D'Onza 2003:191). This trend seems to be supported globally, with 69% of the internal auditors participating in the CBOK study of 2010 indicating that they were using frameworks such as COSO when assessing the effectiveness of control systems (Alkafaji, Hussain, Khallaf & Majdalawieh 2010:24).

Similarly, the International Standards Organisation (ISO) developed a standard known as *ISO 31000 – Risk Management* in 2009 (ISO 2009) that sets out pertinent principles and guidelines. The ISO risk management framework (ISO 2009:10-12) contains several sub-steps that guide the implementation of a risk management system. However, for purposes of understanding the role of the IAF, the most relevant section is on monitoring and review: this includes the review of all aspects of the risk management process, with particular emphasis on ensuring that both the design and effective implementation of internal controls are optimised (ISO 2009:20). This is therefore an area in which the IAF can play a valuable role in the corporate governance environment.

Indications are that the inclusion of internal auditing in risk management is gaining momentum. This is supported by a survey of all its members, performed by the IIA in 2010, which noted that 72% of respondents performed financial risk audits. This placed it as the third most-performed type of audit. In addition, respondents saw the audit focus shifting towards ERM over the next five years as the second most important growth field after corporate governance (Allegrini *et al* 2010:xvi). The respondents also rated risk-based planning as one of the top five audit tools that they use (Allegrini *et al* 2010:9).

The standards discussed above are in line with the guidelines contained in King III, which was published in South Africa during 2009. King III follows the principle of 'apply or explain' because compliance with it is not compelled by legislation (IoDSA 2009: 2-5). Even though compliance with King III is not legally required, all companies registered on the Johannesburg Stock Exchange (JSE) are required to adhere to these principles (IoDSA 2009:4-5). As part of the compilation of the King III report, certain risk management responsibilities were identified and codified as the responsibilities of either the board, the audit committee and/or the internal auditors (IoDSA 2009). The board is required to ensure that risk assessments are performed on a continuous basis, to develop the risk management framework, perform risk management monitoring through management, and to receive assurances on the effectiveness of the risk management process (IoDSA 2009). This is normally established through the development of a RMD, which manages these roles on behalf of senior management (IoDSA 2009:65-69). The audit committee, if assigned the role by the board, is responsible for the oversight of the risk management process, assisting the board in fulfilling its responsibilities for risk management, and approving and reviewing the IAF's risk-based plan (IoDSA 2009:54-81). The IAF should provide independent assurance in relation to risk management, without accepting accountability for its implementation. Furthermore, the IAF should provide an annual written assessment of the effectiveness of the risk management process (IoDSA 2009:69).

Although the South African Companies Act (RSA 2008) does not compel the formation of a risk management function, it does allow for an audit committee to conduct its affairs and to comment on controls as it considers appropriate (RSA 2008: Sec 94(7)). In contrast, Gates (2006:81) notes that the Sarbanes-Oxley Act (SOX) in the United States of America has provided significant incentive for organisations to employ formal risk management techniques. Their Securities Exchange Commission asks boards to implement risk management as part of their assurance processes (Leech 2013:3; Beasley, Clune & Hermanson 2005:522), and in fact, combining ERM with SOX's methods, and adding internal audit risk management assurance is highly recommended (Leech 2013:3).

However, several studies indicate that the IAF is not performing this role as well as it should be (Coetzee & Lubbe 2011:55; De Zwaan *et al* 2011; Karagiorgos *et al* 2009; Sarens & De Beelde 2006; Ţurlea & Ştefănescu 2009:213; Vinnari & Skærbæk 2014). For example, the IAFs are only reviewing financial risks and not the whole spectrum of risk management (Allegrini et al 2010:xvi), i.e., they are not taking into account operational risks (Fernández-Laviada 2007: 144).

3.3 The need for internal auditors to use risk-based audit planning

The second aspect of the IAF's role in risk management relates to risk-based auditing, the process of identifying, auditing and reporting on the most crucial risks facing an organisation by reviewing the controls associated with addressing those risks (Hematfar & Hemmati 2013:2088). Risk-based auditing goes a step further than the traditional audit techniques; it looks at more than just audit risks and focuses on business risks as well (Hematfar & Hemmati 2013:2090). Although it is a fairly new concept, with the proper implementation it could result in more effective and efficient audits (Coetzee & Lubbe 2013:113).

Nearly a decade ago Sarens and De Beelde (2006:13) noted that the core activity for IAFs was still assessing the effectiveness of internal controls, and that, at that time, internal audit had not yet begun focussing on assessing the effectiveness of risk management or the implementation of risk-based auditing. In a later study, Soh and Martinov-Bennie (2011:612) found that IAFs had now moved to more risk-based auditing (particularly around operational risks), and that there was now less emphasis on 'tick and flick' audits.

Nevertheless, the assessment of the internal controls is still very important and has been identified as one of the key areas in which audit committees seek comfort from the internal auditors (Sarens, De Beelde & Everaert 2009:91). However, if a risk-based audit approach is adopted (through risk-based planning), as is required by the IIA (IIA 2013:7), the most important internal controls of material risks will be reviewed. This is supported by the IIA's Standards, King III's principles and the *Public Sector Risk Management Framework*, which all state that the IAF should develop a risk-based plan at the beginning of the year (IIA 2013:9; IoDSA 2009:78; RSA 2010:61). This is followed up by applying a risk-based audit approach, thus focusing on the more critical controls that are essential to achieving the objectives of the organisation (IIA 2013:9; IoDSA 2009:78; RSA 2010: 61).

4 RESEARCH METHODOLOGY

To achieve the research objective, a literature review was performed which shows that internal audit is well positioned to play various roles in the risk management process, and to follow a risk-based audit coverage plan. This was followed by an empirical research component, which, being of a qualitative nature ensured that a sound, elaborative and in-depth approach was followed (Yin 2014). A case study method was selected as it allows for in-depth understanding (Creswell 2009:13). It is regarded as the most effective approach, as case studies are by nature more focused on explanatory questions (how and why), which best relate to the objective of this research: to investigate the role of internal auditing in risk management in the mining sector (Yin 2014).

One of the limitations of a case study is that the findings do not automatically have universal applicability; however the relevant themes occurring throughout the interviews could still be used in the same environment (Yin 2014). In order to ensure that triangulation of data and sources occurs, and thereby strengthens the integrity of the data, multiple case studies were selected instead of only one (Yin 2014). This also assisted in managing the limitations, as it made it possible to replicate and evaluate the results of the case studies on an individual as well as a combined basis (Yin 2014).

The mining sector was specifically selected for this research due to its importance to the economies of many particularly developing countries. In emerging markets in particular mining is essential to their development, as it is a source of cash inflows, and because it increases export capacity and job creation (Broadberry & Irwin 2007:262; Fedderke & Pirouz 2000:2; Jenkins 2004:23; Jerven 2010:81). The juxtaposition of the strategic importance of the mining industry to South Africa's economy with the Marikana tragedy, and recognising how quickly the prolonged strike action escalated into deadly violence (claiming the lives of 44 people), (Botiveau 2014; Ledwaba 2013), it has become clear that risk management in this sector is very relevant, topical and strategically important. That this was followed by another prolonged period of labour unrest across the country's mining sector, with additional negative impact on the country's economy, reinforces the need to assess attitudes and approaches to risk management in this sector. These events placed risk management in this sector under intense public scrutiny. With internal auditing being well positioned to play an important role in risk assessment, it is hoped that they will be encouraged/allowed to contribute their expertise to the risk management arena, and help avoid similar events in future.

In order to increase the general applicability of these findings, three multinational mining companies with operations in South Africa were selected as case studies. All three of the organisations have implemented risk management processes and have IAFs working alongside combined risk and audit committees. This allowed for a review of organisations that are similar in the maturity of their control and risk environments, which would further strengthen the integrity of the data.

In selecting the individual participants for the research, stakeholders, as identified in the literature as important role players in risk management, were considered. Four categories of participant were identified, namely: the audit committee; executive management; the RMD, and the IAF. The audit committee is regarded as an integral component of the risk management process (De Zwaan *et al* 2011; IoDSA 2009; Sarens, De Beelde & Everaert 2009:91), and for this reason audit committee members were selected as participants in the research. The Chief Financial Officers (CFOs) of the targeted organisations were selected because of their close working relationships with the IAFs and RMDs, as well as with the members of their organisations' audit committees (Eulerich, Theis, Velte & Stiglbauer 2013:59; Sarens & De Beelde 2006). The CFOs represent executive management, and are ultimately responsible for their organisations' risk management processes (Sarens & De Beelde 2006:15; Starr, Newfrock & Delurey 2003:79). With regard to the IAFs, due to the direct involvement of internal audit in the risk management process (De Zwaan *et al* 2011; Karagiorgos *et al* 2009; Sarens & De Beelde 2006; Ţurlea & Ştefănescu 2009:213; Vinnari & Skærbæk 2014), the Chief Audit Executives (CAEs) were selected as participants. Similarly, the direct involvement of the RMD in managing the process resulted in their inclusion as participants (Burnaby & Hass 2009:540; COSO 2004:6; IoDSA 2009:22; ISO 2009:22). By obtaining the views of four participants, representing four different functions, in each of three multinational mining companies, robust triangulation opportunities were created (Yin 2014).

During August and September 2014 the researcher performed semi-structured interviews with 11 participants and received a documented response from the 12th participant. The written response was based on the interview questions, all of which were intended to elicit their views (Creswell 2009:181). The interview questions were informed by the literature review and are set out in Annexure A. One of the weaknesses of interviews is that deficiencies in (interviewer) recall and reference biases may occur (Yin 2014). In order to address this, the interviews were recorded and independently transcribed, and the transcripts of the interviews were sent to the participants for final review. The data was then analysed according to themes and perspectives by using Atlas.ti. This involved, as was suggested by Creswell (2009:184-187), generating categories of information by using a combination of predetermined and emerging codes, and connecting these categories to position them within the context informed by the literature review. Ethical clearance was obtained for the research during July 2014. A list of interview questions was e-mailed to the participants before the interviews and they were requested to sign letters of consent before participating in the research. CAE participants were further requested to provide background information on their companies. This questionnaire sought information on the number of employees in the company; number of employees in the IAF; number of the employees in the RMD; structure and reporting lines of the IAF; and the structure and reporting lines of the RMD.

5 RESULTS AND DISCUSSION

Using the questions in Annexure A as a reference point for this section, the following results were noted and have been structured into five separate and distinct themes. The different viewpoints of the stakeholders involved were grouped by function, as far as possible, to provide a unified expression of stakeholder expectations and viewpoints.

5.1 Organisational structure

All three of the organisations participating in this study are multinational entities that are listed on several stock exchanges, including the JSE. The organisations' employee bases range from tens of thousands to hundreds of thousands of employees, who are also supported by several thousand contractors. Similarly, the sizes of the IAFs range from a total of 22 (in South Africa only) to between 41 and 56 employees deployed globally. The RMDs have an average of four employees (stationed in the central RMD, with responsibility for policy and procedure creation), and they are supported by line RMs. In two of the organisations the IAFs and RMDs are separate departments, while in the third the functions have been combined, and have the task of creating policy and procedures for risk management as well as assurance over the risk management process. They report directly to the CAE.

All the CAEs report functionally to a combined risk and audit committee; two report administratively to the CFO, while the third reports administratively to the Chief Executive Officer of the organisation. The above structures are acceptable in terms of the IIA Standards as they allow the IAFs the required independence to perform their roles (IIA 2013:4).

5.2 Current and expected roles for the IAF and RMD

All of the participants had very similar viewpoints on the current and expected roles of their IAFs and RMDs.

With regard to the IAF, all participants concurred with the view of a CFO participant that

"… the role is an important one, to give objective feedback to management, the line and also to more senior management, and ultimately the governance layer, whether it's the board or other governance areas, that the processes are in place, they're working effectively, and that the risks are being properly identified and managed."

A CAE participant added: *"It [the IAF] is there as assurance for the board and to the extent there needs to be a critical control over this process and verification undertaken that has to be pushed back to management."*

Because of the importance of the IAF's involvement in the risk management process, there are three essential areas in which participants require the IAF to play a role: these are a risk management assurance view of the process; a risk-based audit approach, and an assurance that the controls are working effectively.

A CFO participant explained the IAF's contribution to the risk management point of view:

"What's the methodology or the process which the organisation which it's looking at has in place to manage risk, to make sure that is robust in its … design."

The participant then referred to the effectiveness and consistency with which management deploys the risk management process across their organisation, including reviewing the material risks facing the organisation, as the product of a risk-based audit approach.

In addressing the third essential area, the IAF is then required to review and assess the adequacy and effectiveness of the controls that have been implemented to manage the risks identified.

The three key areas identified by the participants are therefore mirrored in the key findings from the literature review in that a risk-based audit approach alongside assurance over the risk management process of the organisation is exactly what the stakeholders require. Furthermore, even though the stakeholders wish to have a risk-based approach, they also have a very strong requirement that the IAF provides an opinion on the effectiveness and design of the controls over the risks themselves.

With regard to the role of the RMD in the process, all the participants agreed on what they expected from their RMDs - that risk management is not solely the responsibility of the RMD. As one of the RM participants stated: "*risk management [is] every line manager's role*."

The main responsibility of the RMD is to support the line managers in their efforts to know and own their risks and the controls to mitigate and control those risks. The RMD should "*leave the accountability for the risks with the line who are in best position to* *assess and understand those risks"*, as a CFO participant stated. The RMD should provide robust methodologies that assist line management in effectively assessing risks in a standardised manner across the organisation. All of the participants also agreed that this is not a role that should be played by the IAF, which should maintain its independence throughout this process.

A number of specific areas were identified where sharper focus and improvements within the IAF in the future would ensure that they remain relevant and add value to their organisations. The four areas respondents identified are: to increase the strategic role of internal audit, including increasing technical expertise; to provide a holistic review of the risk management process; to ensure that a robust and consistent approach to risk management is implemented by management; and to ensure that the risks to sustainability faced by the organisation are taken into account.

Addressing these four areas in more detail, a few of the participants identified that the IAF should play a more strategic role in future and should focus on the strategic risks within an organisation. As a CAE participant explained:

"I think we are sitting at the right tables; we are sitting at Exco, Manco, audit committees and so forth. If you're looking at the integrated reporting framework and what King is saying is that we should look at the process much more strategically."

This requirement is closely aligned with the literature review, which also indicated that the IAFs need to become more strategically involved.

Support for the strategic role requires an increase in technical expertise – a need that the participants also identified. As a CFO participant noted:

"… the internal audit function should have in-depth knowledge of the top risks of the company (financial, operational, and strategic) and be able to effectively review and suggest improvements."

Secondly, all participants shared an expectation that a full, holistic review of the risk profile of the organisation should be performed to ensure that all risks have been taken into account, and especially in the organisation's key focus areas. A CAE participant believed that internal audit should be a role player *'in ensuring the risk profile, or risk register for an organisation, is holistic - and by holistic I mean is recognising emerging risks that are facing the company'*. The participant made the further point that internal audit should also consider the possibility that management had perhaps incorrectly described the risks, or had not fully understood the impact the risks might have.

Arising from the promotion of a holistic review of the organisation's risk profile, the third area for improvement all participants agreed on was the expectation that the IAF work closely with the organisation to ensure that the approach to risk management is consistent, systematic and enforced. According to a RM participant, the involvement of the IAF is valuable because

"… there is also a benefit to be derived from taking all of the learnings that the internal audit function gleaned from all of their work across different locations and sharing that information. It's a very useful information-sharing tool."

This point was supported by the view of a CAE participant who said:

"I think our internal audit function can bring some of that to bear in terms of what we see in the field and trying to get that level of consistency across the development of the risks within the organisation."

The fourth and final focus area for the IAF with regard to providing risk management assurance may very well be specific to the mining industry. This includes the identification and review of sustainability risks (and their associated controls) that the organisations may face. A CFO participant made the following observation:

"Sustainability is an area of increasing importance, with the triple bottom line, expectations, … and that's growing … and I know boards are expecting internal audit to play more in that area. They look to internal audit to give them assurance on health, safety, environmental, [and] community type areas."

This requirement in itself may therefore have a direct impact on the technical skills that an internal auditor requires in order to provide assurance over such processes in future.

Combined with the above sustainability risks, the ability of the organisation to continue to perform its business functions if a risk should materialise was also of importance to the participants. This was especially true for the RM participants in the study, who believed that it was important to have practical controls in place to protect business continuity. A RM participant stated:

"I've worked through plenty of contingency plans … and a lot of these are these thick documents that the guys draft for business continuity plan but … when disaster strikes, they cannot use it because it's just a lot of theory and it's sitting there somewhere in a drawer."

Another RM participant concurred with this view and suggested that *"… business resilience is the answer to that one, or business continuity; but I don't think many companies have fully tackled it."* These views indicate a clear need to have some sort of assurance over business continuity in future, which could fall within the mandate of the IAF.

5.3 Risk-based auditing

As noted in the literature review, the use of a risk-based approach in the performance of audits has become critical for IAFs as they increasingly focus on the critical risks facing the organisation. This idea was supported by all 12 participants interviewed, who believe that IAFs must follow a risk-based approach in order to add value and to maintain their relevance. One of the audit committee (AC) participants even went so far as to state that *"you absolutely have to have a risk-based approach because otherwise I think you gonna [sic] be dead in the water."* This was supported by another CFO participant who felt that: *"if the IAF is a box-ticking exercise they're less helpful."*

Similarly, all the participants believed their IAFs had implemented a risk-based approach to the performance of their audit activities and that this has assisted them in maximising the resources available; hence the comment: *"a risk-based approach under-pins our ability to be able to divert resources [previously allocated] to less risky areas into high-risk areas."* However, a few CAE participants did acknowledge the possibility that not all of their processes were covered by a risk-based audit approach at this stage.

An area of concern that was raised with regard to the risk-based audit approach. The point was made that this approach should not be a rigid one. In other words, it should not be assumed that the risks identified at the beginning of the year will have retained their relative critical importance to the organisation when their specific section/audit comes up later in the year. As a CAE participant explained: *"if you get to August of 2015, [and] we [are] still doing risk-based audit on your risks of July 2014 … [this] is absolutely crazy and that's absolutely not risk-based."* Another CFO participant suggested that if the risk management register was adequate and if an effective risk management process was in place, then the IAF could be *"quite sure that the top risks are the right risks"* to focus on. The IAF would therefore need to ensure that a thorough review of the risk management process is performed, as well as ensuring the completeness and accuracy of the risk profile (as suggested above), in order to ensure that the data used for the risk-based audit approach remained reliable.

5.4 Issues affecting the effectiveness of internal audit in risk management

The participants were asked if there were any specific regulations or components of legislation that might hamper the effectiveness of the IAF with regard to risk management. One AC participant indicated that he was not aware of the fullest extent of the regulations and legislation that guide the IAF, while eight respondents indicated that they did not think the audit function was being limited by rules and regulations. The remaining three participants (two CAEs and a CFO) were concerned that adhering to the strict requirements of the IIA Standards could compromise the independence of the internal auditors. These concerns were consistent with the views on the impact of resource constraints, as well as the conflict that may sometimes arise between the organisation and the IAF when a review of the risk management process occurs.

The requirements of the IIA and other regulatory bodies, and the effect these have on the available resources of the organisations, were noted as one of the areas that hamper the effectiveness of the IAF. A CAE participant believed that ways should be explored in order

> *"… to free up those resources to execute this work. Because clearly, our stakeholders [are] saying they want more assurance work in risk management, but I can't do more assurance work and to a higher standard [with these resources], so there is a real tension there at the moment. And I think that ultimately, we'll probably need to start to look to some reform, potentially in a regulatory space, either from the relevant stock exchanges or in fact the IIA that controls the [Standards], to relax some of those."*

The next most important issue identified was maintaining independence from management when performing the risk management assurance work. One CAE participant stated: *"I think independence remains the biggest issue … so you have to watch your step the whole time in terms of, are you still independent or not when you're doing it."*

This view was supported by two other participants (a CAE and a CFO), who felt however, that the IAF might be trying to hide behind independence in order not to make difficult decisions. A CAE participant believed that *"internal auditors have been hiding behind independence for a very long time, and many of … us are actually hesitant to come too close to the independence line."* A CFO participant made the point that if the independence of internal audit is over-emphasised, the IAF may be

> *"… losing some of its potential impact. Now clearly there are some areas where you maybe don't want to play, where it would impact objectivity, and objectivity is the word I would use more so than independence for an internal audit function."*

The last area of concern identified by respondents, that might hamper the effectiveness of the IAF in the risk management process, was described as a natural tension between the IAF and the organisation. One RM participant observed that, even though a positive relationship exists between the IAF and management,

> *"naturally, there's always that sense of a little bit of tension, healthy tension I think, to go through that discussion, [to] challenge each other on really what's important… At times that relationship can be tested."*

While a healthy tension is required and is usually beneficial, as noted above, if that tension is not healthy, then the IAF may find itself in a difficult position. According to a CAE participant, *"there's a bit of a push back against audit lately because they see us as a stick; they don't see us necessarily as a business partner."*

5.5 Methods and techniques to improve the value added by internal audit in risk management

The participants had a variety of viewpoints with regard to the value being added by the IAF. There was a similar diversity of views on the methods and techniques that can be used by the IAF to improve its assurance work over risk management (including the relationship between the IAF and the RMD); the value it adds to the risk management process, and the risk-based approach that they follow. There were also some very obvious common themes in the views expressed by participants, and many of these may have been influenced by the specialised nature of the mining industry in which the participants work.

Nevertheless, this section should be read in conjunction with the current and expected roles of an IAF as explained above, as many of the new approaches suggested by the participants will certainly add value to the risk management assurance role performed by the IAF.

The majority of the participants were in agreement that their IAFs are adding value to the risk management process. However, the reasons offered for such beliefs varied, particularly between different participant categories. The CFO participants mainly perceived that value was added because the IAF reviewed the risk management process from end to end, and therefore ensured that the controls in place to mitigate the risks were in fact effective and efficient. As a CFO participant stated: *"Our internal audit [function] is a significant role player in identifying lacking or ineffective controls over various risks in the organisation and suggesting improvement on these controls, as well as actively monitoring implementation of improvements."*

Two of the AC participants believed that their IAFs are adding value through the interaction between the IAF with the RMD, in that they can ensure that they are focusing on key and material risks when they review the risk-management process. However, in striking contrast to the general consensus, one of the AC participants did not think that the IAF was doing enough to add value to the risk-management process, noting that, due to rigidly held and conflicting views between the risk owners and the IAF, a stalemate situation obtained, in that *"at the end of the day, you landed up almost agreeing to disagree."*

Similarly, one of the RM participants believed that *"right now we're probably not getting enough value and I think that's partly a reflection on where we are in our broader organisational journey."* The other RM participants, however, believed that value was being added to the risk management process, principally through the independent review being performed by the IAF and the value the review has in assisting the RMDs to perform their roles. At the same time their IAFs managed to ensure that they did not overstep its boundaries, noting that: *"the independence is still there: if they found something that could improve they will tell us, and we appreciate that."*

All of the CAE participants agreed that their IAFs were adding value through performing assurance work on the risk management processes, and that the holistic, end-to-end view that they provide was the best evidence of this. One CAE explained that this approach *"has allowed us to … understand the issue, put in place a remediation plan and move forward to ensure that gap doesn't persist going forward … without compromising our assurance work which is first and foremost for the purpose of the audit committee."*

As previously noted, most of the participants agreed that they were receiving value from the IAF through the review of their risk management processes. However, they had further suggestions on how to increase the IAF's value. Many ideas were presented, but the one that was consistently identified concerned the technical expertise that is required by the IAF in order to be able to perform their work in a mining/resource extraction environment. Due to the nature of the mining industry, the significant majority of risks faced are not related to "normal business", but are much more technical in nature, e.g., fall of ground; isolation of energy sources before working, and water purity management amongst others. As a CFO participant observed: *"It's not just finance areas and controls. It's not just even supply or HR etcetera, or IT areas. It does bring you into areas of technical operational risks, asset integrity, resources, mine planning, etc."* He believed that *"the audit skill sets and the knowledge that needs to be brought to bear to properly assess and evaluate"* these industry-specific risks require internal auditors to consider *"the right designs for those controls to mitigate the risk, or prevent the risk, and that they're working effectively,"* and this expectation *"brings new challenges in terms of what skill sets do you have within the internal audit function."* In order to successfully address these issues requires skills that are not ordinarily available to an internal auditor who typically only has an accountancy-based audit background. A RM participant suggested adopting a multidisciplinary approach to mitigate this because

"… internal audit needs access to the right resources, internal or external, and … it can't just be a bunch of auditors going around because they cannot … have all of the required skill levels for all of the different disciplines [at play on a mine]."

Two CAE participants mentioned that their organisations have already implemented processes to address the technical skills issue, in that combined assurance reviews now make use of the specialised skills of technical employees to review these risks. A third CAE participant reported that her organisation was in the process of implementing such an approach. This in itself raises a pertinent question about the way forward for the IAF. One approach is for the IAF to upskill its employees to master all of these technical skills, while an alternative approach is for the IAF to acquire staff members with technical skills but no audit experience, and to train them on the requirements of an audit engagement. A third alternative could be to train the audit staff to be better at providing assurance over the whole risk-management process (big picture), while simultaneously guiding the technical people to apply their expertise to analyse specific risks, and then integrating the two sets of data.

With regard to the interaction between the RMD and the IAF, all but one of the participants (an AC member) believed that there was effective interaction between the two departments. The dissenting participant however, did not believe that there was any co-operation between the departments at all. Even though all the other participants believed that there was a 'good' relationship between the two functions, they also believed that this could be improved, even if only slightly. More inclusive and more continuous communication between the two functions was the main area needing improvement, as was identified by the two CFOs, one RM and one CAE participant. As the CAE participant explained: *"I think it's always a case of making sure people keep the lines of communication open, to share knowledge, and not just to wait until it's that formal time of the year."* This view was supported by a RM participant, who stated: *"…yes, we have to communicate much more, and see each other much more, challenge each other much more."*

The most challenging and therefore most interesting question asked of all participants was whether the IAF and the RMD could assist the company to avoid a 'black swan' event. Three of the participants (an AC, a CAE and a CFO) indicated that they didn't believe that there was anything that the IAF could do to prevent 'black swan' events, least of all a Marikana-type tragedy. The remaining nine participants believed that the IAF might well be able to assist in predicting a 'black swan' event, even another Marikana. However they were unsure of the level of assistance that could be provided. The concerns expressed by these participants were around challenging the completeness of the risk profile and ensuring that adequate resources had been used when the risks were being reviewed.

A CAE participant encouraged internal auditors to change their mind-sets, to demonstrate a broader view: *"I think from a risk management perspective, continually challenging and encouraging management to ensure there is sufficient diversity of thinking in terms of potential causes and the potential impacts of a particular incident, remain ever important."* Without meeting that challenge one may end up with a very narrowly framed risk, and associated controls that are very weak.

This CAE participant did also point out that while challenging management, the IAF should nevertheless be sure to maintain its independence.

"On the flip side of that though, in our internal audit function I think the challenge there is that, whilst I encourage my internal audit team to challenge management on their diversity of thinking, their role is not necessarily to say [that] management … has described the risk incorrectly."

6 CONCLUSION

This research was undertaken to investigate the role of an IAF in risk management in the mining sector. This was done by obtaining the perceptions of four of the stakeholders most closely associated with each of the IAFs. Thus the CFOs, RMs, CAEs and an AC member of each of the three selected South African mining companies were interviewed, guided by questions that were formulated after a thorough review of available literature.

The findings confirmed that overall, the IAFs are successfully performing and are expected to continue to perform the main functions of assurance over the risk-management process, while maintaining a risk-based audit approach at all times. Similarly, the participants were also in agreement that the RMD should perform an oversight role regarding policies and consistent implementation of risk management efforts, while the line management should take operational accountability for the day-to-day risk management activities.

With regard to the effectiveness of the relationship between the IAF and the RMD, all participants noted that it is critical that these functions work together closely, to obtain as much information as possible from each other, to ensure that the overall risk profile of the organisation is as near complete and accurate as is possible. Challenging the completeness of the risk profile and the robustness of the review of these risks may, in the opinion of the participants, actually assist management in identifying a possible 'black swan' event in their own organisations. Once identified, management can then allocate the appropriate resources and skills to evaluate and assess this potential event. This close working relationship could also assist in managing one of the issues that may otherwise hamper the effectiveness of the IAF's participation in risk management, namely the tension between the IAF and the organisation whereby management may be reluctant to share all the required information in order to avoid being 'hit with the stick' if things do go wrong.

All the participants indicated that the roles that their IAFs are playing are the roles that they wish them to play. However, in future these IAFs will need to focus their attention on specific mining-related areas and methods in order to provide more value to their stakeholders. Four areas were identified, namely: to fulfil a more strategic role; to follow a holistic approach ensuring all risks are considered; to follow a robust process and consistent approach; and to consider sustainability risks.

Perhaps the single most important one of these areas is the need to increase the capabilities of the internal auditors themselves when it comes to the technical and operational risks that the mining industry faces daily. Strongly supporting the call to increase the technical skills of the IAF is the requirement that it starts achieving a more strategic focus. This will require the IAF to identify not only the business and operational risks, but also the strategic risks that the organisation is exposing itself to – and this will most likely need to be performed with fewer resources than are currently available to the IAF.

All participants supported the implementation of a risk-based internal audit approach, but a few CAE participants acknowledged that not all processes within their organisations are covered by such an approach. Although CAE participants in general did not perceive the internal audit profession's rules and regulations to negatively impact the effectiveness of the IAF in relation to risk management, their independence remains an area of concern. Most of the participants agreed that internal auditors add value in risk management. The reasons cited varied between participant categories: however, there was general consensus that the value added by IAF could increase if their technical expertise in relation to the mining industry improved. This would require an expanded skillset for internal auditors.

In order to provide the correct assurance over the risks and the effectiveness of the design and application of controls to mitigate these risks, the internal auditors will need to understand these risks intimately. Future mining-based IAFs will therefore be faced with two options: either work very closely with technical experts within the organisation in a combined-assurance type of approach while simultaneously increasing their own technical skills, focusing on ensuring the completeness of the risk management profile and the consistent application of the organisation's risk management policies, or by obtaining the required technical skills through in-house appointments or training.

One of the limitations of this case study is that the findings cannot be generalised much beyond the mining industry in South Africa. However, the recurring themes identified by the respondents could be used in the same environment. Despite these limitations, the study has made a valuable contribution to understanding the gap previously noted between the required role of internal audit in risk management and the role that they are currently playing. This has been achieved by identifying the respondents' requirements for improvement within the IAF that would maintain the IAF's relevance to the mining sector into the future.

Because of the unique aspects of the IAF in the mining sector, future academic research needs to be performed on the role of internal audit in risk management in other sectors of the economy, in order to determine if there are any similarities in the future roles of the IAF. Similarly, research is needed to determine the best approach for the IAF to obtain new, industry-specific technical skills (regardless of industry), and what impact these skills are likely to have (or have already begun to have) on the effectiveness of the IAF in the risk-management process. Research could also include the impact this may have on the composition of the IAF as far as its needs for general audit skills versus technical audit skills are concerned. Lastly, research could also be performed to identify exactly what role IAFs should play with regard to identifying strategic risks, and what impact this role might have on their independence.

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APPENDIX A

Interview questions the participants were asked

Interviews were performed with the CAE, CFO, RM and an appropriate AC member, and included the following questions:

1 In the ideal world, which role do you expect internal audit should play to manage an organisation's risks?

2 How do you perceive the role of your organisation's IAF in relation to risk management?

3 How can your organisation's IAF close the gap between your expectations and the actual role they are playing in risk management?

4 What current rules and regulations of internal audit hamper the effectiveness of your risk-management assurance processes?

5 What are your views on a risk-based audit approach for your organisation's internal auditors?

6 What are your views on the value added by your organisation's IAF to its risk-management process?

7 What do you perceive to be the role of your organisation's RMD?

8 What are your views of the relationship and interaction between your RMD and its IAF?

9 How can this relationship and interaction be improved?

10 What do you believe internal audit and the RMD could have done to prevent a 'black swan' event like Marikana?

11 Do you have any other comments on your organisation's risk-management processes in relation to its IAF?

SOUTHERN AFRICAN JOURNAL OF ACCOUNTABILITY AND AUDITING RESEARCH

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Editorial requirements

A General

The *Southern African Journal of Accountability and Auditing Research* (SAJAAR) is the research journal of the Southern African Institute of Government Auditors (SAIGA).

The Southern African Institute of Government Auditors is an independent Institute which aims to advance accountability and auditing in particular.

The publication of a fully accredited scientific journal in South Africa is one of SAIGA's contributions towards advancing accountability and auditing in our country. It is also designed to assist in the professionalisation of auditors and government auditors in particular. The Institute's premise is that uncensored scholarly debate will contribute towards the development of the disciplines that strengthen accountability and auditing in particular. SAIGA endeavors to ensure that important accountability concepts and the external audit function in particular, are not marginalised.

B Accreditation of the journal (SAJAAR)

The *Southern African Journal of Accountability and Auditing Research* is accredited by the South African Department of Higher Education and Training as a research journal and contributions (articles) qualify for subsidies which the Department of Higher Education and Training grants to tertiary institutions in this regard.

C Fields of interest covered

With this scientific journal it is intended to provide a wide coverage of the issues that are subject to scholarly debate around accountability and auditing preferably with emphasis and focus on the public sector. The topics and debate should consequently be directed at *accountability* and *auditing in the public sector*, albeit in a broad context. Research projects directed at accountancy or the education of *accountants* fall outside the intended scope, unless a direct relation is established and identified between the phenomenon under investigation and either *auditing* or *accountability*. Internal auditing is also not the main focus of this journal, unless a public sector perspective is linked to the internal auditing research topic. Preference will be given to contributions that address *accountability* and *auditing* elements and topics directly in a public sector context.

Opportunities to publish scholarly work focusing on the broader accountability framework are limited and related research findings have to compete with material submitted for publishing on subjects such as Economics, Management and Accounting in existing South African journals. The establishment of a research journal focusing on accountability and auditing (with a focus on the public sector) therefore heralds a new age for these key disciplines in Southern Africa. It is also an attempt to ensure that the public sector is not marginalised.

D Sequence of publication

The *Southern African Journal of Accountability and Auditing Research* is published annually.
Should sufficient acceptable manuscripts be received to warrant more than one issue, SAIGA will consider publishing more than one issue per year.

The normal publication date is towards the end of a calendar year.

E SAJAAR readership

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- South African legal deposit libraries
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- libraries of professional bodies in South Africa
- selected staff from the Auditor-General South Africa
- other senior role players in South Africa's public sector
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The submission of an article for publication in *SAJAAR* activates a reviewing process that involves expert knowledge and linguistic editors. Although the Institute levies certain charges (for example page fees) this only covers a small percentage of the publication and distribution costs. It is therefore important that authors realise that the editorial requirements set out below are designed to create an effective, efficient and economical reviewing and publishing process. Strict adherence to these basic requirements is therefore essential.

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H The reviewing and publishing process

(a) Upon receipt of a submission, the SAIGA Secretariat checks the completeness of the submission and adherence to the editorial requirements as well as topic relevance and communicates with the authors(s) in this regard.
(b) Once the submission is complete and the editorial requirements adhered to, the article is entered into the reviewing process. From this point onward, the author(s) are not allowed to withdraw the article and SAIGA has the right to publish it.
(c) The Editor will provide the author(s) with feed-back from the members of the Editorial Board, suggestions to improve the article and necessary changes to get the article in a format for publishing.
(d) The Institute, through SAJAAR's Editor, may inform the author(s) that the article cannot be published and allow the author(s) to withdraw the article.
(e) Should the Editor decide that the article is publishable if the necessary changes are made and suggestions for improvement are affected, the article will then be sent for linguistic editing and improvements made.
(f) The author(s) then have to pay the linguistic fees and any administration fees that may have incurred. A single invoice will be made out to the "representative author" who has to fax a copy of the deposit slip as proof of payment to the SAIGA Secretariat.
(g) Based on the outcome of the linguistic process, the response to the reviewers' feed-back and other communications, the Editor will inform the author(s) of the acceptance of the article for publication or other conditions that have to be met before publication.
(h) The full page fees are then payable. A single invoice will be made out to the "representative author" who has to fax a copy of the deposit slip as proof of payment to the SAIGA Secretariat.
(i) All outstanding fees (linguistic and page fees) have to be paid within a month from the date of the invoice and proof of payment presented to the Institute. The journal will then be printed and published, including the articles of all authors whose fees have been paid. Articles related to unpaid fees will not be published in the current edition, but in the following edition.
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(l) The author(s) will be informed of the publication of the journal and their copies sent to them.

I Elements of the submission

A submission consists of the following four elements:

1 The covering letter by the authors (pdf format)
2 The information sheet (pdf format)
3 The actual manuscript (MS WORD & pdf format)
4 The signed declaration (pdf format).

Details regarding the above requirements are set out below.

1 The covering letter by the authors (containing normal communications)

This letter is addressed to the Editor of SAJAAR and written on the letterhead of the author/(s) and signed by at least one person. It will contain the normal communications and no specific requirements as to the contents thereof are set.

The covering letter must be submitted as a pdf file and the file name must be constructed as follows: Surname of author – Covering Letter – date of submission (yyyy-mm-dd).
For example: *Smith – Covering Letter – 2014-04-14*.

2 The information sheet

A typed page (in a separate file) on which the following information must be provided:

2.1 the full title of the article
2.2 the full name(s) and surnames of the author(s)
2.3 the title(s) of the author(s)
2.4 their academic status
2.5 their current place of employment
2.6 the name of the institution (for example University) that needs to be disclosed next to their name (for purposes of accreditation of refereed articles)
2.7 the name of the "representative author", the person who will be responsible for receiving and answering any correspondence and who will be responsible to pay the linguistic and page fees (only two invoices will be made out: one for the linguistic fees and one for the page fees)
2.8 postal address to which all correspondence may be sent (one elected representative address in the case of multiple authors)
2.9 e-mail address (one elected "representative author" and his/her address in the case of multiple authors)
2.10 contact telephone and fax numbers of the "representative author"
2.11 the details to whom the invoice(s) must be made out and a VAT registration number if available
2.12 a list of key words for cataloguing purposes.

The information sheet must be submitted as a pdf file and the file name must be constructed as follows: Surname of author – Information Sheet – date of submission (yyyy-mm-dd).
For example: *Smith – Information Sheet – 2014-04-14*.

3 The actual manuscript

The manuscript submitted for consideration must adhere to the following *technical standards*:

3.1 Be typed in Microsoft WORD in *double spacing* and paginated. All submissions must be prepared using MS WORD. Conversions from other word processing packages are not acceptable.
3.2 Be typed in the Arial font with an 11 point spacing (this applies to both main text and any endnotes that may be used).

3.3 Be free of any footers or headers or other graphics, lines and blocks sometimes used to enhance documents (blocks around each page, etc.).
3.4 Have a first page on which only the title of the article is printed together with an abstract (approximately 100 words) of the article (no names of authors on this page).
3.5 Be typed in such way that the names of the author/(s) do not appear in the actual manuscript (this does not apply to their names being listed in the bibliography or other references).
3.6 Be in either English or Afrikaans.
3.7 The use of abbreviations in the manuscript should be avoided as far as possible.
3.8 It is strongly recommended that authors have their manuscripts reviewed for language proficiency before submitting them, as excellent submissions sometimes have to be drastically amended or even rejected because of linguistic ineptitude. The editor reserves the right to make *minor* editorial adjustments without consulting the author (also refer to the condition of final linguistic editing as set out under the heading "The reviewing and publishing process").
3.9 The manuscript has to be submitted in the following electronic formats: one MS Word file *as well as* one pdf file.
3.10 The file name must be designed in the following format: author's surname – short title of the article – date of submission (yyyy-mm-dd). For example: Smith – *Accountability in the public sector – 2013-11-01*. Where a second author is involved, give second author's surname after first separated by a "-". *For example: Smith – Jones – Accountability in the public sector – 2013-11-01.* Where more than two authors are involved use "et al" after first author. For example: *Smith et al – Accountability in the public sector – 2014-04-14.*

The following ***reference technique*** must be followed:

3.11 References should be inserted into the text by indicating in brackets the name of the author(s) and the year of publication of the quotation for example "...Jones (2013) states that...", or "...that the going concern concept is not applicable for these purposes" (Jones 2013).
3.12 If reference is being made to a specific page, a colon follows the year of publication (no spaces), followed by the page number (again, no spaces), for example: "...Jones (2013:18) states that...", or "...that the going concern concept is not applicable for these purposes (Jones 2013:18).
3.13 If the specific author has more than one publication in any one year, the articles are distinguished by inserting the letters a, b etc. after the year of publication, for example: "...Jones (2013a:18) states that...".
3.14 Footnotes may not be used for reference purposes.

The ***Bibliography*** has to be prepared according to the following standards:

3.15 Publications referred to in the text are listed alphabetically by surname of the first author.
3.16 References to the same author appear in the sequence of publication, and if an author has more than one publication in any one year, the articles are distinguished by adding the letters a, b etc. after the year of publication (see standards for the *reference technique* above).
3.17 In the case of articles in journals, details of each article should appear in the bibliography in the following sequence: surname, initials (or names, if used in the original publication), year of publication, title of article, name of journal (in italics), date or number of journal. In the case of books, details of each book should appear in the bibliography in the following sequence: surname and initials (or names, if used in the original publication), date of publication, title of book (in italics), name of publishers and place of publication.
3.18 The bibliography is not subdivided into sections for books, journals, papers, etc.

Examples:
Jones, P. 2017. The Going Concern Concept. *Auditing SA.* January:page number(s).
Jones, P. 2013. *Auditing.* 2nd edition. Pretoria: Unipret Publishers.

Jones, P., James, C. & Johnson, B.C. 2013. The Going Concern Concept. *Auditing SA.* January 2013.

Gay, G., Schelluch, P. & Reid, I. 2011. Users' perceptions of the auditing responsibilities for the prevention, detection and reporting of fraud, other illegal acts and error. *Australian Accounting Review*, 7(1):51-61.

Lawrence, G.M. & Wells, J.T.Y. 2013, *Basic Legal Concept.* [Online].
http://www.aicpa.org/pubs/jofa/oct2004/lawrence.htm
(Accessed: 12 December 2013).

Southern African Institute of Government Auditors (SAIGA). 2014. *Common Body of Knowledge and Skills for Registered Government Auditors, CBK 001*. January, SAIGA. Pretoria: Menlo Park.

The following *layout standards* have to be adhered to:

3.19 Each drawing or table must be provided with a concise, unique heading.

3.20 Footnotes should be avoided as far as possible. Footnotes are only permissible when it is necessary to clarify a specific point, and it is undesirable to include the explanation in the text, because the logical flow of the argument may be disrupted. Such footnotes appear at the bottom of the page to which they refer. On each page footnotes start with number 1.

3.21 Endnotes are permissible.

3.22 The use of bold typeface in the text should be avoided as far as possible. Accentuation should be done by using italic typeface. Foreign words (e.g. pro rata, status quo, etc.) should be in italic typeface.

3.23 Direct quotations from other publications should be avoided. Such quotations are only permissible in exceptional circumstances when the specific quotation is so succinct and vivid that the text may be materially enhanced by the quotation.

3.24 Headings are numbered 1, 2 etc., and sub-headings 1.1, 1.2 etc. More than three characters (points excepted) in a sub-heading (points excepted) are not permissible. All headings and sub-headings appear adjacent to the left margin in bold (not capital letters). If bold typeface is not available, headings and sub-headings are underlined.

3.25 Acknowledgements of financial and other assistance should be formulated in an end note.

3.26 Acknowledgements of a highly personal nature are not permissible.

Other *administrative rules* that are applicable:

3.27 The submission must be e-mailed to *secretary@saiga.co.za* and addressed to: The Editor, SA Journal of Accountability and Auditing Research. No other e-mail address may be used.

3.28 Incomplete or off-standard manuscripts are not returned. Authors are notified by the Secretariat and a new set of manuscripts and/or other elements of the submission must be lodged with the Institute.

3.29 It is a condition of acceptance that, irrespective of any linguistic work already done on the article, each article will be sent to the Institute's linguistic editors before final publication (for details regarding linguistic fees see above).

3.30 SAJAAR does not accept manuscripts that are submitted to other journals.

3.31 No new manuscripts may be submitted to review and publishing if any fees, relating to previously published articles by an author, are still outstanding.

3.32 Authors(s) have to undertake not to submit the manuscript to another journal, until such time as SAJAAR's Editor, has informed the author(s) that the article cannot be published and has allowed the author(s) to withdraw the article.

3.33 If the manuscript has previously been submitted to another journal and withdrawn or rejected by that journal, the correspondence in this regard will have to be submitted.

3.34 Manuscripts that have been read at conferences or disclosed at public forums or events, whatever nature, are not appreciated and will only be considered in exceptional circumstances.

3.35 Copyright of published articles is transferred to the *Southern African Journal of Accountability and Auditing Research*.

3.36 Each author will receive five complimentary copies of the *Southern African Journal of Accountability and Auditing Research* (authors can obtain more copies on request at a nominal price).

3.37 SAIGA has instituted an annual *Research Award*. Articles published in the scientific journal *SAJAAR* are automatically eligible for the *SAIGA Research Award*. A panel of international experts, comprising of academics and senior government auditors make a recommendation to the Council of the Institute which makes the final decision. The *SAIGA Research Award* aims to encourage and support independent research and discourse. The *SAIGA Research Award* is not an annual event, but its occurrence will be determined by the Executive Committee of SAIGA.

4 The signed declaration

The author(s) have to sign a declaration stating the following (please note that the specimen letter available on our website [in pdf format] has to be used to comply with this requirement):

4.1 That the manuscript is submitted to SAIGA with the full intention of having it published in the Southern African Journal of Accountability and Auditing Research.

4.2 That they understand the reviewing and publishing process followed by SAIGA and that they agree to submit the manuscript under these conditions and rules.

4.3 That the article constitutes their original work; that other authors' work has been quoted by applying normal practices in this regard; that they indemnify the Institute from any copy right infringement which may result from the publishing of the manuscript.

4.4 That the manuscript has not been submitted to another journal or if it has been submitted to another journal and withdrawn or rejected, they must provide SAIGA with the correspondence in this regard.

4.5 That the manuscript has not been read at any conference or disclosed at public forums or events, whatever nature or published in any form whatsoever.

4.6 That they understand that the manuscript may not be withdrawn or submitted to another journal whilst the reviewing process is underway, unless the Editor specifically allows the author(s) to withdraw the article.

4.7 That they agree to the conditions of payment of the linguistic and page fees.

The signed declaration must be submitted as a pdf file and the file name must be constructed as follows: Surname of author – Signed Declaration – date of submission (yyyy-mm-dd).
For example: *Smith – Signed Declaration – 2014-04-14*.

5 Electronic submissions only

Submissions can only be done electronically. The submission must be e-mailed to *secretary@saiga.co.za* and addressed to: The Editor, SA Journal of Accountability and Auditing Research.
No other e-mail address may be used.
File names must be constructed in the required file format.
Every submission must contain FIVE files: covering letter (pdf); the information sheet (pdf); the manuscript (MS Word and pdf) and the signed declaration (pdf).

The South African Qualifications Authority (SAQA) has recognised The Southern African Institute of Government Auditors as a professional body for the purpose of the National Qualifications Framework Act, Act 67 of 2008.

The professional designation "Registered Government Auditor" (RGA) is also registered on the National Qualifications Framework (NQF) for the purposes of the NQF Act of 2008.

The Southern African Journal of Accountability and Auditing Research

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