

# **Critical Considerations to Strengthen the Internal Audit Function in Public Institutions**

## **The Role of Auditing Committees**

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### **ABSTRACT**

There is an inevitable widening of the scope of the internal audit function, however, in South Africa the internal audit function is still in its early development stages and focuses mainly on compliance and financial audits, as opposed to the wider context of financial management. The role of audit committees is to enhance good governance and accountability and to strengthen the internal and external audit functions, financial management as well as the overall governance of public institutions. Consequently, it strengthens the position of the internal audit function by acting as an independent forum internal auditors could consult with on matters affecting financial management. The article found that internal auditing reporting improved in public institutions where the audit committee has a strong influence on internal auditing practices and audit reports clearly detailed audit findings and explained thoroughly how the internal auditor reached certain conclusions and/or opinions. If an audit committee carries out its work effectively, it serves as an effective means of monitoring and promoting a system of good governance within any institution. Hence, audit committees are not merely passive watchdogs when it comes to governance issues – they are expected to take an active lead in ensuring sound financial governance in a public institution.

### **INTRODUCTION, BACKGROUND AND RATIONALE**

As noted above, there is an inevitable widening of the scope of the internal audit function, however, developing countries, such as South Africa, where the internal

audit function is still in its early development stages, may still define the internal audit function narrowly, focusing only on compliance and financial audits, as opposed to wider management issues (Allen *et al.* 2013:378). Furthermore, Papageorgiou, Yasseen and Padia (2012:11829) indicate that in South Africa, the internal audit profession was only formally introduced in 1984, with the formation of the Institute of Internal Auditors of South Africa (IIA SA). The academic and professional research on the practice of internal auditing has thus been sporadic.

Several authors asserted that the role of audit committees is to promote accountability and to strengthen the internal and external audit functions, financial management and overall governance (Sarens & De Beelde 2006:459; Badara & Saidin 2014b:178; Nevondwe, Odeku and Tshoose 2014:268). Allen, Hemming and Potter (2013:390) cite that a strong internal audit function in the public sector is dependent on an effective audit committee. Furthermore, the presence of audit committees creates the perception that the internal audit function is independent, which may lead to more reliable financial reporting (Christopher, Sarens and Leung 2009:204; Vafaei & Christopher 2014:15).

In addition, Allen *et al.* (2013:374) posit that the internal audit function is an important part of internal management controls, and it functions by reviewing, evaluating and making recommendations for the improvement of other internal controls within an institution. The role of internal auditing is thus two-fold. First, it provides a leader of a public institution with an objective and independent opinion on the trustworthiness of operations of the institution. Second, the findings and recommendations of an internal audit function should provide management of a public institution with input that enables them to take corrective action in an effort to improve the effectiveness of the operations of the institution and its overall internal controls. This reiterates the importance of the role of an audit committee as an enabler to the audit function. A strong working relationship between an audit committee and internal audit function members is critical, to enable each to fulfil their responsibilities to senior management and other stakeholders. Hence, regular review meetings between members of an audit committee and internal audit function members are necessary in order to ensure that audit committee members stay informed about issues related to their monitoring responsibilities (Christopher *et al.* 2009:204; Vafaei & Christopher 2014:15).

In terms of the reporting line of the chief audit executive (CAE) (i.e. an executive who is responsible for the overall functioning of an internal audit function), this incumbent should report to the audit committee. Moreover, if the CAE reports to senior management instead of an audit committee, it has the potential to result in internal auditors failing in their duty to recommend adequate controls that will protect a public institution against fraudulent activities (Sarens & De Beelde 2006:459–460; Christopher *et al.* 2009:208; Alzeban & Sawan 2013:446). Furthermore, the independence of an internal audit function is compromised if

management is responsible for appointing and dismissing the CAE. In the same vein, if management influences the budget of the internal audit function, its independence may be compromised. The audit committee should thus be the one that approves the budget for the internal audit function (Christopher *et al.* 2009:208). It is believed that if an audit committee has the executive responsibility for the management of its internal audit function, instead of this role residing with the accounting authority, this could go a long way in promoting the independence of the internal audit function.

As noted above, it has been found that in public institutions where the audit committee has a strong influence on internal auditing practices, such as influencing the audit plan instead of management playing this role, audit reports clearly detail audit findings as well as explain thoroughly how the internal auditor reached certain conclusions and/or opinions (Sarens & De Beelde 2006:459–460; Christopher *et al.* 2009:208). This, however, does not take away the fact that a chief executive officer (CEO) and/or a chief financial officer (CFO), that is, the executive who is responsible for the overall financial planning, record keeping, and financial reporting of an institution, should provide input to the internal audit function, given that they are able to identify high-risk areas that have to be considered by the internal audit function. However, the CAE and the audit committee should still have a final say in the audit plan (Sarens & De Beelde 2006:459; Christopher *et al.* 2009:208).

Several authors have explained the role of an internal audit function using agency as well as communication theories. First, an agency relationship is regarded as a contract that is entered into between leaders of an institution and its management (Al Mamun, Yasser & Rahman 2013:38; Khaled & Mustafa 2013:92). Managers are regarded as agents of the leaders, and as such, perform work on behalf of the leaders. However, there is a possibility that the managers may deviate from conducting their duties in the manner expected, and instead pursue their own interests. This situation can be monitored by the presence of corporate governance mechanisms, such as audit committees, external and internal auditors who can ensure that managers perform their duties as expected by the leaders (Al Mamun *et al.* 2013:38; Vafaei & Christopher 2014:7).

Second, communication theory argues that the existence of effective communication between internal auditors and auditees, and between members of a public institution at large is important in strengthening internal audit effectiveness. To this end, the manner in which internal auditors communicate their findings is critical. For example, if internal auditors communicate their findings in a way that auditees perceive as accusatory or only identifying weaknesses, this may break trust between internal auditors and auditees, which may in turn create communication barriers. Effective communication is thus critical, and the communication process should focus on relaying only necessary information, in a clear, simple

and meaningful way, as well as on creating mechanisms for feedback (Alzeban & Sawan 2013:445; Khaled & Mustafa 2013:94–95).

In addition, the Institute of Internal Auditors (IIA) is an organisation that was founded in the United States of America in 1941 (IIA 2018:1). It is a professional association that promotes the development of the practice of internal auditing, and it has over 76 400 members in 141 countries, including South Africa. It is also the recognised authority, chief educator, and acknowledged leader in standards, certification, research and technological guidance for the internal audit profession throughout the world (Institute of Internal Auditors Research Foundation (IARF) 2003:2). Furthermore, the Treasury Regulations of 2005, stipulate that, internal audits in the public sector must be carried out in accordance with the standards of the IIA (National Treasury 2005:9).

Khaled and Mustafa (2013:92) highlight that there is a lack of research that evaluates the effectiveness of the internal audit function, when compared to external auditing. Furthermore, there is a need for research in this area, especially in developing countries, where the internal audit function could play a critical role in preventing unethical conduct, such as fraud (Badara & Saidin 2014b:177; Khaled & Mustafa 2013:92). This article aims to address this gap. In this context, the article is structured as follows: first, it provides conceptual clarification of the terms relevant to the context of this study; second, it addresses the statutory and regulatory framework for the internal auditing function; third, it discusses the membership and composition of audit committees; fourth, it explains the functions of audit committees; and fifth, it highlights aspects related to the audit committee charter. It then discusses the effectiveness of the review function of audit committees followed by the need for expertise and skills of audit committee members.

## CONCEPTUAL CLARIFICATIONS

**Internal auditing** for the purposes of this article is defined as an independent appraisal function established to examine and evaluate institutional activities, with the objective of promoting effective control and assisting institutions, including management, to discharge their responsibilities effectively (Willson & Root 1984:2; D'Silva & Ridley 2007:117). Willson and Root (1984:3) further define internal auditing as a function that is responsible to the owners of an institution, and which provides a service to senior management. The services provided include, inter alia, monitoring management controls as well as being proactive in identifying and assessing risks to institutional assets and activities. Other services are investigating lapses in controls that have occurred and those that have a potential of occurring and making recommendations for improving responses to risk and achieving institutional objectives.

If a public entity has a board or other controlling body, the board or controlling body is the **accounting authority** for that entity. If the public entity does not have a controlling body, as is the case with SASSA, the CEO of the public entity is the accounting authority (RSA 1999a:46).

Other terms used for the additional aspects that are now part of the internal audit function, as highlighted above are 'management' or 'operational auditing' and in some instances, 'performance auditing' or 'value-for-money auditing'. An operational audit aims to assist management in improving the operations of an institution, as well as in achieving efficiency, effectiveness and economy in their delivery of goods and services (Pollitt & Bouckaert 2011:86; Allen *et al.* 2013:378; Vafaei & Christopher 2014:4–6). In this article, '**effectiveness**' relates to the extent to which a public institution achieves its predetermined objectives (Prowle 2010:257). **Efficiency** entails the ratio of resource inputs compared to service outputs, that is, doing well and comprehensively, without wasting time and/or resources (Prowle 2010:257).

The term '**internal audit effectiveness**', however, refers to the ability of internal auditors to achieve set objectives of the internal audit function (Badara & Saidin 2014a:76; 2014b:180). Similarly, Cohen and Sayag (2010:297–298) cite that the effectiveness of internal auditing is determined by the subjective evaluations given to the function by management. Enofe, Mgbame, Osa-Erhabor and Ehiorobo (2013:163) posit that the internal auditor's work is not done until shortcomings have been corrected and remain corrected. Internal audit effectiveness in the public sector should thus be evaluated by the extent to which it contributes to the demonstration of effective and efficient service delivery, as this contributes to driving demand for improved internal audit services. Effective internal auditing is thus necessary in undertaking independent evaluations of financial and operating information and of systems and procedures, as well as in providing useful recommendations for improvements when deemed necessary.

Badara and Saidin (2014b:176) emphasise the importance of having an effective and efficient internal audit function, by citing that if an internal audit function carries out its work well, it serves as an effective means of monitoring and promoting a system of good governance within any institution.

## **STATUTORY AND REGULATORY FRAMEWORK GOVERNING THE INTERNAL AUDITING FUNCTION**

This section focuses, *inter alia*, on the internal audit sections of the Public Finance Management Act 1 of 1999 (PFMA) (sections 76 and 77) and considers the role that an internal audit function could play. The promulgation of the PFMA was a positive step in promoting fiscal discipline and transparency in the management

of public finances. The PFMA, read together with the Treasury Regulations of 2005 on the implementation of the Act and the Public Audit Act 25 of 2004 (RSA 2004b) provide the necessary requirements for effective financial management. The consequences of not adhering to the PFMA are also stated in the Act itself. The PFMA is clear in its intention to legislate for an efficient and effective public financial management system. The rules-driven and prescriptive nature of financial legislation thus necessitated the passing of Acts that provide a framework for an efficient and effective public financial management system that eliminates waste in the use of public financial resources and corruption (Bekker 2009:11).

The main objectives of the PFMA, therefore, are to streamline the system of financial management in the public sector and empower public sector managers to manage, but at the same time to be held more accountable. In addition, the aim of the PFMA is to ensure that the financial information provided by public institutions is of high quality, is provided on time, and that waste and corruption in the use of public finances are eliminated (RSA 1999a:1). The PFMA, thus, aims to promote the effective and efficient use of financial resources.

Bekker (2009:15) emphasises that the PFMA has played a key role in better and consistent reporting, improved financial management, and detailed reports that provide additional information on how public funds are spent within the national and provincial spheres of government. This is because the PFMA is performance- and output-orientated, among other things. The PFMA stipulates that accounting officers in departments and accounting authorities in public entities are required to submit measurable objectives for each main division within a departmental budget vote. In addition, the accounting officers and accounting authorities are required to account for progress made on the aforementioned measurable objectives in their annual reports. This should assist in ensuring accountability and service delivery.

The PFMA, therefore, is one of the most important pieces of legislation that the democratic government has promulgated, as it legislates for the effective and efficient use of public financial resources, in order to enable the provision of public services to all South Africans (Bekker 2009:15).

One of the objectives of the PFMA is to promote accountability in the public institutions to which the Act applies (RSA 1999a:12). In this regard, section 51(1) of the PFMA requires accounting authorities of public entities to establish a system of internal audit that is managed by an audit committee. Section 51(1) of the PFMA lists the general responsibilities of accounting authorities of public entities, and one of these is that accounting authorities must as noted above establish a system of internal audit, which is managed by an audit committee. The system of internal audit should comply with and operate according to regulations and instructions stipulated in sections 76 and 77 of the PFMA. Section 76 of the PFMA lists all the matters on which the National Treasury may make regulations or issue

instructions. Section 77 stipulates the composition of audit committees. Sections 76 and 77 of the PFMA are described briefly below.

Sections 76(1) and 76(2) list the circumstances under which the National Treasury must make regulations or issue instructions applicable to public institutions. These are regulations pertaining to financial misconduct (legal definition: fruitless, wasteful, unauthorised and irregular expenditure), financial management, internal control and audit committees. Additionally, the appointment of audit committees and their functioning as well as the running of internal audit functions are stipulated in sections 76(1) and 76(2) of the PFMA (RSA 1999a:61–63).

In terms of the Treasury Regulations of 2005, Regulation 27.2 (Internal controls and internal audit) deals with the implementation of sections 51(1)(a)(ii) and 76(4) (b) and (e) of the PFMA and requires the following (National Treasury 2005:81–82):

- “27.2.1. The accounting authority of a public entity must ensure that a risk assessment is conducted regularly to identify emerging risks in the public entity. A risk management strategy, which must include a fraud prevention plan, must be used to direct internal audit efforts and priority and to determine the skills required of managers and staff to improve controls and to manage these risks. The strategy must be clearly communicated to all employees to ensure that the risk management strategy is incorporated into the operations of a public entity.
- 27.2.2. All public entities to which these regulations apply must have an internal audit function.
- 27.2.3. A public entity and subsidiaries under the ownership control of the entity may have a shared internal audit function.
- 27.2.4. The purpose, authority and responsibility of the internal audit function must, in consultation with the board (if there is one), be formally defined in an audit charter and be consistent with the definition of internal auditing according to the IIA.
- 27.2.6. Internal audits must be conducted in accordance with the standards set by the IIA.
- 27.2.7. The internal audit function must, in consultation with the audit committee, prepare:
  - (a) A rolling three-year strategic internal audit plan based on its assessment of key areas of risk for the public entity, having regard to its current operations, the operations proposed in its corporate or strategic plan and its risk management strategy.
  - (b) An internal audit plan for the first year of the rolling plan.
  - (c) Plans indicating the scope of each audit in the annual internal audit plan.

- (d) Reports to the audit committee detailing its performance against the plan, to allow effective monitoring and intervention when necessary.
- 27.2.8. The internal audit function must report directly to the accounting authority and shall report at all audit committee meetings. The function must be independent of activities that are audited, with no limitation on its access to information.
- 27.2.9. The internal audit function must co-ordinate with other internal and external providers of assurance to ensure proper coverage, and to minimise duplication of effort.
- 27.2.10. The internal audit function must assist the accounting authority in maintaining effective controls by evaluating those controls to determine their effectiveness and efficiency, and by developing recommendations for enhancement or improvement. The controls subject to evaluation should encompass the information systems environment, the reliability and integrity of financial and operational information, the effectiveness of operations, safeguarding of assets; and compliance with laws, regulations and controls.
- 27.2.11. The internal audit function must assist the accounting authority in achieving the objectives of the institution by evaluating and developing recommendations for the enhancement or improvement of the processes through which objectives and values are established and communicated. Furthermore, the accomplishment of objectives must be monitored, accountability ensured and organisational values preserved”.

Regulation 27.1 (Audit committees) of the Treasury Regulations deals with the implementation of sections 51(1)(a)(ii) and 76(4)(d) of the PFMA (National Treasury 2005:80–81) and requires that:

- “27.1.1. The accounting authority of a public entity must establish an audit committee as a sub-committee of the accounting authority.
- 27.1.2. A shared audit committee may be established for a public entity and any subsidiaries under the ownership and control of that entity.
- 27.1.3. The chairperson of the audit committee must be independent, be knowledgeable, that is, have the requisite business, financial and leadership skills. Additionally, the chairperson of an audit committee may not be a person who fulfils an executive function in the public entity.
- 27.1.4. The majority of the members of an audit committee must consist of non-executive members appointed by the accounting authority,

and they must be financially literate. The audit committee members, therefore, need not all be employees of the public institution. The Institute of Internal Auditors (2014:12) cites that various governments have expressed independence requirements of audit committee members. This can be seen in Australia's state of New South Wales, where audit committees are required to have a majority of independent members and that these independent members must not hold any other public sector roles in that state. The Auditor-General of New Zealand and the International Federation of Accountants, recommend that most audit committee members should be external appointments. Furthermore, the Canadian government requires that a majority of audit committee members be from outside government.

- 27.1.5. The relevant political office-bearer must agree to any premature termination of services of a member of an audit committee.
- 27.1.6. The audit committee must operate in terms of written terms of reference, which must deal adequately with its membership, authority and responsibilities. The terms of reference must be reviewed at least annually to ensure relevance.
- 27.1.7. It must be disclosed in the public entity's annual report whether or not the audit committee has adopted formal terms of reference and if so, whether the committee satisfied its responsibilities for the year, in compliance with its terms of reference.
- 27.1.8. The audit committee must, amongst other things review the following:
  - (a) The effectiveness of the internal control systems;
  - (b) The effectiveness of internal audit;
  - (c) The risk areas of the public entity's operations to be covered in the scope of internal and external audits;
  - (d) The adequacy, reliability and accuracy of financial information provided to management and other users of such information;
  - (e) Any accounting and auditing concerns identified as a result of internal and external audits;
  - (f) The public entity's compliance with legal and regulatory provisions;
  - (g) The activities of the internal audit function, including its annual work programme, co-ordination with external auditors, the reports of significant investigations and the responses of management to specific recommendations; and
  - (h) Where relevant, the independence and objectivity of the external auditors.

- 27.1.9. The audit committee must have explicit authority to investigate matters within its powers, as identified in the written terms of reference. The audit committee must be provided with the resources it needs to investigate the matters and must have full access to information. Furthermore, the audit committee must safeguard all information supplied to it within the ambit of the law.
- 27.1.10. The audit committee must –
- (a) Report and make recommendations to the accounting authority;
  - (b) Report on the effectiveness of internal controls in the annual report of the public institution; and
  - (c) Comment on its evaluation of the financial statements in the annual report.
- 27.1.11. Should a report from internal audit (or any other source) to the audit committee implicate the accounting authority or any other officials in fraud or gross negligence, the chairperson of the audit committee must promptly report this to the relevant political office-bearer and the Auditor-General.
- 27.1.12. The audit committee must communicate any concerns it deems necessary to the political office-bearer, the Auditor-General and if appropriate, to the external auditor.
- 27.1.13. The audit committee must meet at least annually with the Auditor-General or the external auditor, whichever is applicable, to ensure that there are no unresolved issues of concern”.

Furthermore, as noted above, the Treasury Regulations: PFMA stipulate that, internal audits in the public sector must be carried out in accordance with the standards of the IIA (National Treasury 2005:9).

In terms of the local sphere of government, the Local Government: Municipal Finance Management Act 56 of 2003 (MFMA) (Section 166) states that every municipality and municipal entity must have an audit committee, but provides that a single audit committee may be established for a district municipality and its local municipalities in that district, or for a municipality and its municipal entities. However, as administratively expedient as such joint audit committees may be, one submits that they lose some of their effectiveness because they become too broadly focused. Ideally, therefore, municipalities will strive to establish their own dedicated audit committees which can give the necessary attention to local governance and risk management issues (Auriacombe and Fourie 2019:54).

Regulation 9 of the Municipal Planning and Performance Management Regulations promulgated in 2001 under the Local Government: Municipal Systems Act 32 of 2000 (cited in Auriacombe and Fourie 2019) obliges a municipality to appoint a separate Municipal Performance Audit Committee to conduct

the internal audit of the municipality's performance. The Regulations (cited in Auriacombe and Fourie 2019) further provide clear guidelines on how municipal performance audits must be conducted namely:

- “review the quarterly reports submitted to it;
- review the municipality's performance management system and make recommendations in this regard to the council of the municipality; and
- at least twice during a financial year submit an audit report to the municipal council concerned” (Municipal Planning and Performance Regulation 2001 Regulation 4(a)(i)-(iii) in Auriacombe and Fourie 2019).

The Municipal Performance Audit Committee is critical in improving the oversight role of the municipal council, as it reviews the performance of management and determines whether management in their execution of municipal projects adhered to the legislative framework governing performance management. The committee may access municipal records for the purpose of auditing, may summon anyone and may request information from anyone (Municipal Planning and Performance Regulation, 2001 Regulation 14(4)(iii) in Auriacombe and Fourie 2019).

In terms of the Municipal Planning and Performance Management Regulations a municipality (presumably, the council) must annually appoint and budget for a performance audit committee, consisting of at least three members, the majority of whom may not be involved in the municipality as a councillor or an employee. The performance audit committee must include at least one person who has expertise in performance management, and the council must designate a member of the performance audit committee, who is not a councillor or an employee of the municipality, as chairperson of such committee (Auriacombe and Fourie 2021:45).

A performance audit committee must, according to Auriacombe and Fourie (2021:46):

- review the quarterly reports submitted to it in terms of these regulations;
- must review the municipality's performance management system and make recommendations in this regard to the council; and
- must at least twice during each financial year submit an audit report to the council.

In reviewing the municipality's performance management system, the committee must focus on economy, efficiency, effectiveness and impact, as far as the key performance indicators and performance targets set by the municipality are concerned (Auriacombe and Fourie 2021:45).

Auriacombe and Fourie (2021:45), state that to perform the foregoing duties, the committee may:

- communicate directly with the council, municipal manager and the internal and external auditors;

- access any municipal record containing information necessary to perform its duties or exercise its powers;
- request any person to attend any of its meetings and, if necessary, provide information requested by the committee; and
- investigate any matter it deems necessary for the performance of its duties and the exercise of its powers (Auriacombe and Fourie 2021:46).

## **MEMBERSHIP AND COMPOSITION**

It is obvious from all the foregoing requirements that the membership of the audit committee is a key element in the determination of its effectiveness. The key to the effectiveness of an audit committee is having members with an appropriate mix of skills and experience relevant to the responsibilities of the organisation. The ideal composition of an audit committee and attributes of its members depend on different factors, such as the size, complexity and responsibilities of the institution. In the main, audit committees have between three and eight members with typical audit committees having four or five members. Generally, the minimum number of members for an effective audit committee is three, as this ensures that a sufficient range of skills and experience are available (IIA 2014:10).

Section 77 of the PFMA states the following about audit committees (RSA 1999a:63):

- a) Audit committees must comprise of at least three persons of whom:(a)
  - i) One must be from outside the public service,
  - ii) The majority may not be persons in the employ of the public institution, except with the approval of the relevant treasury, and
  - iii) The chairperson may not be in the employ of the public institution.
- b) Must meet at least twice a year, and
- c) May be established for two or more departments or institutions, if the relevant treasury considers it more economical.

The board or the accounting authority should elect an audit committee chair. The chair of an audit committee is the central point of communication, and is key to an effective and independent audit committee. The personal attributes of the audit committee chair are important. They must have leadership skills and the courage to raise and tackle difficult issues and encourage others to do the same. They must also understand the importance of relationships with key stakeholders, and should have the interpersonal skills to nurture those relationships as well as build and maintain effective working relationships (IIA 2014:13).

In terms of the MFMA, the members of the audit committee need to have an extensive knowledge of municipal finance and accounting, of the administration

of municipalities generally and of the compulsory legal framework within which municipalities operate. Here, according to Auriacombe and Fourie (2019:58) “perhaps, the Act does not go far enough. It provides that the audit committee must comprise at least three persons with appropriate experience, the majority of whom must not be in the employ of the municipality...The question which is immediately begged is how any employee member of such a committee can truly and transparently claim to be independent of the municipality which functions as his or her employer...Sensibly, the Act provides that no councillor may be a member of an audit committee, but it would have best served the interests of good corporate governance and incisive risk management if this prohibition had also extended to municipal employees...This does not mean, of course, that the municipal manager and chief financial officer, and other members of senior management, should not routinely attend meetings of the audit committee – though mainly in an elucidatory role”.

The MFMA also provides that the chairperson of the committee must be appointed from one of the members who is not in the employ of the municipality, which is a useful approach consistent with the dictates of good corporate governance, but here again it will have to be ensured that such chairperson has independent knowledge, skills and expertise as far as municipal activities are concerned. If the chairperson is dependent on the municipal manager or the CFO for guidance in the compilation, discussion and evaluation of the reports serving before the committee their independence is fatally compromised, and the whole purpose of the committee significantly undermined (Auriacombe and Fourie 2019:59).

The council, if it is a local municipality, may, instead of appointing a performance audit committee, elect to make use of the performance audit committee of the district municipality in whose area it falls, and that performance audit committee will then be regarded as the performance audit committee of the local municipality. If the local municipality elects to make use of the performance audit committee of the district municipality, it must notify that district municipality of its decision, and make suitable arrangements with the district municipality regarding the availability of its performance audit committee. The council may use any audit committee established in terms of other applicable legislation as its performance audit committee (Auriacombe and Fourie 2019:60).

Auriacombe and Fourie (2019:59) argue that “given that the foregoing Regulations were drafted a few years before the enactment of the MFMA it is perhaps understandable that there may be some discrepancies between the approach followed in the Regulations and that adopted in the Act in regard to audit committees...The most important difference lies in the fact that the Regulations allow the council to appoint a councillor to serve on its performance audit committee, whereas this is pertinently prohibited in the case of an audit committee... If the council therefore wishes to make use of its audit committee, as constituted

in terms of the Act, also to serve as its performance audit committee – an approach which makes eminent sense, given that the audit committee is charged with the responsibility of evaluating the municipality’s performance management, and that a separate performance audit committee may constitute, an unnecessary duplication of resources and give rise to a possible conflict of duties – the council will have to adhere to the requirements of the Act and appoint only outside parties and (if absolutely necessary) its officials to serve on its audit/performance audit committee”.

## **FUNCTIONS OF AUDIT COMMITTEES**

The IIA (2014:6) highlights that audit committees play an important role, which includes improving and providing transparency on matters of governance, risk management and internal control practices in public sector institutions. Part of the function of an audit committee in relation to risk management is to oversee the information technology (IT) risks and fraud risks as these relate to financial reporting and internal financial controls, which includes reporting to the board on the effectiveness thereof (KPMG Advisory 2009:2). Other typical audit committee responsibilities are:

- reviewing and providing oversight on the systems and practices established by management to set and sustain high ethical standards; and
- monitoring compliance with laws, regulations, policies and standards of ethical conduct (IIA 2014:9).

Audit committees thus play an independent oversight and advisory role, leaving the responsibility for decision-making to management. This points to the fact that audit committees do not make executive decisions. If an audit committee is involved in making decisions, this may affect its objectivity and ability to remain independent, negatively. An audit committee is a key component of the governance structure of a public institution, and effective committees are able to assist boards or accounting authorities and a CAE in ensuring high-quality internal and external reporting. Effective audit committees are also able to strengthen the independence of the audit activity (KPMG Advisory 2009:7; IIA 2014:6).

In terms of local governance, the MFMA further stipulates that an audit committee must be an independent advisory body that must do the following:

- Advise the council, its political office bearers, the accounting officer and senior management on matters relating to:
  - internal financial controls;
  - internal audits;
  - risk management;

- accounting policies;
- the adequacy, reliability and accuracy of financial reporting and information;
- performance management;
- effective governance;
- compliance with the MFMA, the Annual Division of Revenue Act 2 of 2013, and other applicable legislation;
- performance evaluation; and
- any issues referred to it by the municipality.
- Review the annual financial statements of the municipality to provide the council with authoritative and credible views on its financial position, its efficiency, effectiveness and overall level of compliance with applicable legislation;
- Respond to the council on issues raised by the Auditor-General in the annual audit report;
- Carry on investigations into the financial affairs of the municipality as requested by the council; and
- Perform such other functions as may be prescribed.

## **THE AUDIT COMMITTEE CHARTER**

An audit committee charter should establish an audit committee mandate, and outline the roles and responsibilities of an audit committee and its members. Such charter should establish the authority to obtain information and required resources, and outline the respective roles and responsibilities of internal and external stakeholders who have an obligation to interact with the audit committee. The process for developing, reviewing and updating the charter and the frequency of review must also be outlined in the charter. Best practice suggests that a charter must be reviewed annually and modified as required. The board of an institution should review and approve the charter. Once established, the charter should be maintained and communicated within the institution. Best practice further suggests that an audit committee charter should be published in publicly available material and on the website of the institution. This would enable key stakeholders to have easy access to the charter (IIA 2014:8).

In the context of local governance, it is also important for the sake of both the council and the audit committee that the council adopts an audit charter, which regulates the activities of the committee. This is done according to Auriacombe and Fourie (2019:63) by setting out the following:

- overall objectives;
- duties and responsibilities;
- authority; and
- organisational arrangements.

## **INDEPENDENCE OF THE AUDIT COMMITTEE**

It is necessary to consider in this section, first, the meaning of an independent audit committee in the public sector according to the IIA. The IIA (2014:4) regards an independent audit committee in the public sector as a board-level committee, which is made up of a majority of independent members with a responsibility to provide oversight of management practices in key governance areas. Allen *et al.* (2013:390) highlight that the control environment of a public institution is likely to improve, and reported errors are likely to reduce when an audit committee has a strong influence on the activities of the internal audit function. Independence through an appropriate reporting line is thus considered the most important criterion for objectivity. Independence is further improved if the audit committee has the necessary technical expertise in fields such as accounting and budgeting, in order to understand the work of the internal audit function.

Furthermore, an audit committee member is deemed independent if they are not employed by or providing any services to the public institution beyond their duties as a committee member. The composition of an audit committee is critical, and a committee should be made up of a majority of external members. Its chair and members should demonstrate inquisitiveness, outspokenness and courageousness. Best practice personal attributes of audit committee members include sound judgement, objectivity and integrity, a healthy constructive scepticism, a high level of ethics, and strong communication skills. Audit committees thus support public sector institution boards or accounting authorities by providing oversight of governance, risk management and internal control practices, as well as help build trust and confidence in how public institutions are managed (IIA 2014:6–7).

For example, in terms of the local sphere of government, as an independent advisory body, an audit committee must not be susceptible to influence from the council, its structures, political office bearers or its officials. The independence of the committee will be best assured by appointing persons who have no connection whatsoever with the council in its current operations (Auriacombe and Fourie 2021:70).

## **EFFECTIVENESS OF THE REVIEW FUNCTION OF AUDIT COMMITTEES**

D'Silva and Ridley (2007:120) posit that audit committees should review and approve the activities of the internal audit function, as well as monitor and review its effectiveness. It is believed that this will contribute to establishing a good working relationship between an audit committee and an internal audit function in the latter's roles of assurance and consulting and its processes of risk management,

control and governance. An audit committee will only be able to review the work of the internal audit function if the members of the committee have the necessary technical understanding of the function's work.

The establishment of audit committees in public institutions is also promoted by the IIA, which in its efforts to improve the effectiveness of internal auditing issued a statement in 1991 entitled *The audit committee in the public sector* (IIA 1991), which stipulates that all public sector institutions should establish audit committees in order to ensure the effectiveness of internal auditors. Once established, as noted before, it is important that the audit committee be independent. An independent audit committee plays a key role in promoting good governance, and in ensuring that there is integrity in reporting and financial controls as well as in ensuring that financial and other risks facing a public institution are identified and managed (Nevondwe *et al.* 2014:268–270). Moreover, an audit committee has to support the internal audit function by ensuring that the latter conforms to the standards of the IIA, clear performance indicators are set, and that the function is sufficiently resourced and skilled. The previously mentioned support is necessary in order for the internal audit function to discharge its responsibilities effectively (Badara & Saidin 2014a:76; 2014b:176).

Auriacombe and Fourie (2021:71) state that “to enable the audit committee to perform its functions effectively, it must have access to the financial records and other relevant information of the municipality or municipal entity and must liaise with the internal audit unit of the municipality”. For the audit committee to fulfil its role as an important role player in the general governance and risk management structure of a public institution, it is important for the committee from time to time to assess its own effectiveness and its impact on the institution's activities, its management, and ultimately the fulfilment of its responsibilities towards the community (Auriacombe and Fourie 2021:71).

In addition, when it comes to assessing the performance of audit committees, Setlhomamaru (2016:227), argues that audit committees must be assessed regularly using a combination of self-assessments and independent assessments, as both assessments have shortcomings when done in isolation. The former entails an assessment done by audit committee members themselves, and a third or external party, such as an auditor-general, does the latter. Setlhomamaru reiterates the importance of assessing the work and performance of members of audit committees in the public sector, as performing and effective audit committees are a necessary condition for good governance (Setlhomamaru 2016:228).

Hence, such an assessment can be done through a self-evaluation of the audit committee's effectiveness by each member of the committee, with inputs from the institution's management and its internal and external auditors. The CAE should preferably evaluate the performance of the individual committee members, and in terms of local governance, the council evaluates the performance

of the chairperson (Auriacombe and Fourie 2021:72). Evaluation criteria will include assessing the expertise and knowledge of members; their attitude, objectivity, judgement and independence; their understanding of and commitment to the committee's duties and responsibilities; the regularity of their attendance at committee meetings and their willingness to devote time to prepare for such meetings; the quality and timeliness of the responses and advice provided by the committee; and, finally, the insight which it demonstrates into the problems and hurdles confronting the municipality, and the intelligence and practicability of the solutions which it offers (Auriacombe and Fourie 2021:72).

A capable, balanced and committed audit committee could make a substantial difference in the public sector by ensuring effective accountability and transparency. There are many similarities between the features of public and private sector audit committees. One noteworthy difference is the public interest feature that applies to public sector audit committees. A high-performing public sector audit committee could help to ensure that there is an objective analysis of information and that information, which supports decisions, is credible. This assists in creating a better future for the communities who are served by the public institutions (IIA 2014:15). High-performing audit committees are thus typically founded on three key pillars:

- the compliance of the audit committee with its formal charter;
- the level of participation of audit committee members; and
- the ability of the committee to initiate value-adding activities and outcomes that are in line with the vision, statutory objectives and strategies of the institution (IIA 2014:17).

The performance of an audit committee should thus be assessed on a set intermittent basis as stipulated in the audit committee charter. Assessments ensure that the audit committee is meeting the requirements outlined in its charter and that its contribution is consistent with the needs and expectations of the institution and, ultimately, government. Overall, audit committee performance and individual member's performance are normally assessed annually (IIA 2014:16).

## **EXPERTISE AND SKILLS OF AUDIT COMMITTEE MEMBERS**

Audit committee members are required to be knowledgeable collectively, or to have expertise in finance and accounting, industry-specific and overall business knowledge, internal and external auditing, risk management, regulatory compliance, law and IT. Furthermore, certain skills and experience may be required due to the nature of the operations of the institution. Best practice requires an audit committee to have at least one person who is a financial expert. It is also important to evaluate competencies periodically in order to align members' competencies with

emerging institutional needs. When a vacancy occurs, this presents an opportunity to assess existing competencies against required competencies, in order to identify gaps that may exist. The responsibility for nominating and appointing audit committee members differs among various countries, as shown below (IIA 2014:15):

- In Australia, CEOs normally appoint audit committee members, which may have a bearing on independence.
- In Scotland, the board (or accounting officer) is responsible for appointing audit committee members.
- In Ireland, secretaries general (human resources) appoint internal members of audit committees from within their own departments, and external members are invited from other government departments, the wider public sector and the private sector.
- In Canada, appointments to audit committees of public entities are made by boards, as recommended by the president of a board, through an appointment order specifying the tenure of the appointment. Appointments to audit committees of federal government departments are made jointly by the board and the Comptroller-General of Canada.
- In South Africa, the board or accounting authority of an institution appoints audit committee members in consultation with the relevant political office-bearer of the particular department.
- In Egypt, a board appoints audit committee members.
- In New Zealand, the Auditor-General recommends that the chair of the governing body or departmental CEO should first appoint the chair of the audit committee. Furthermore, a chair of an audit committee must also be consulted before further appointments to an audit committee are made (Sambo 2017).

If audit committee members are to be effective, it is important that they have sufficient knowledge of the institution. Some of the factors that have an influence on internal audit effectiveness are experience, training, education (including continuous professional education) and professional qualifications. In terms of continuous professional education, Alzeban and Sawan (2013:445–446) highlight that, internal auditors are required to complete 80 hours of acceptable continuous professional education every two years, which provides them with training on new developments in the profession. All audit committee members should thus have or acquire as soon as possible after appointment an understanding of:

- the mission of the institution and current important issues;
- the structure of the institution, including key relationships;
- the culture of the institution;
- any relevant legislation or other rules governing the institution;
- key risks that the institution faces in meeting its objectives; and
- the structures to which the institution is accountable (Sambo 2017).

The institution should thus provide its committee members with orientation training within a reasonable time following their appointment (IIA 2014:12–13).

## CONCLUSIONS

The researcher believes that the responsibilities of an audit committee outlined above illustrate the importance that audit committees play in enabling the internal audit function to perform its duties successfully. Furthermore, the discussion above points to the importance of having audit committee members who have the required skills and personal attributes. Having the required skills and personal attributes would contribute to enabling an audit committee to execute its functions successfully, in turn enabling the internal audit function to do the same.

The true worth of an audit committee is shown in the outcomes that it achieves. Best practice thus calls for institutions to capture their audit committee contributions in their annual reports. Audit committee performance results can be reported either internally (within the institution) or to external stakeholders or both (IIA 2014:20).

The description of the functioning of the internal audit function, as stipulated in the PFMA and Treasury Regulations of 2005 in the PFMA above confirms that most of the PFMA provisions on the implementation of the internal audit function are in line with literature suggestions. However, the stipulation by the PFMA on the reporting line of the internal audit function, as reflected above is not in line with literature suggestions that suggests that in order to maintain or promote the independence of the internal audit function, the CAE should report to the audit committee whereas the PFMA stipulates that the CAE should report to an accounting authority administratively, and to the audit committee functionally.

It is beyond the scope of this article to consider the position of the IIA on the internal auditing profession, as this is the organisation that provides standards of conduct, regulates such conduct and has authority over the profession. In this regard, however, the code of ethics for internal auditors is important as it provides assurance that internal auditors will conduct themselves ethically and professionally when carrying out their work. The core competencies of the internal audit profession, such as the competencies of professional ethics, governance, risk and control are also aspects that need to be considered because these competencies are critical as they ensure that internal auditors deliver good quality audit outcomes.

## NOTE

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*Act (Act No.1 of 1999): A case of the South African Social Security Agency.* Unpublished doctoral thesis. Pretoria: University of South Africa.

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