

# Internal auditing as a corporate governance mechanism

## A comparison between public sector and private sector functions

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### ABSTRACT

*Internal auditing has progressively gained prominence as a corporate governance mechanism. There are some important differences between internal audit practices in the private sector and their counterparts in the public sector, but changes in the public sector have arguably reduced these differences, especially with regard to governance. This study compares specific dimensions of a public and a private sector internal audit function as a component of a more comprehensive corporate governance mechanism, in the context of public sector reforms, including the adoption of governance and management frameworks originating in the private sector. The study is based on primary and secondary data, drawing on the views of similar stakeholders. The findings of the study support the view that even though internal audit functions in South African national departments are perceived to be valid corporate governance mechanisms, they are not yet as well established as those of the listed companies in South Africa selected for this study. The elements where the internal audit functions of the public sector were found to be lacking highlight areas where improvements are needed to achieve a well-established internal audit function as an effective public sector corporate governance mechanism.*

## INTRODUCTION

The significant role played by internal auditing in contemporary corporate governance is widely acknowledged, and the practice is now firmly entrenched. An extensive body of knowledge has evolved pertaining to the internal auditing function (IAF) as part of an effective corporate governance structure (Carcello, Hermanson and Raghunandan 2005:82; Gramling, Maletta, Schneider and Church 2004:233; Holt and De Zoort 2009:71–72; Paape, Scheffe and Snoop 2003:251; Sarens and De Beelde 2006:219-241; Soh and Martinov-Bennie 2011:606; Zain and Subramaniam 2007:899). Much of this prior research has been conducted from a private sector perspective, and examines the relationship between internal audits and other corporate governance role players, such as the executive management (Fadzil, Haron and Jantan 2005:846; Gramling *et al.* 2004:233; Sarens 2007; Sarens and De Beelde 2006:238), the audit committee (Allegrini, D’Onza, Paape, Melville and Sarens 2006:849; Myers and Ziegenfuss 2006:51-61; Sarens, De Beelde and Everaert 2009:91; Turley and Zaman 2004:317), and external auditors (Gramling *et al.* 2004:210–227; Pilcher, Gilchrist, Singh and Singh 2013:331).

It has been argued that, although there are important differences between internal audits in the private sector and their counterparts in the public sector, changes in the public sector have reduced these differences, especially in respect of governance (Goodwin 2004:640,641; PricewaterhouseCoopers 2010:2). This is especially true for South Africa, because the *King Code of Corporate Practices and Conduct 2002 (King II)* published by the Institute of Directors (IoD) has been adopted to a limited extent in public sector entities. PricewaterhouseCoopers (2010) ascribes this move to the pre-emptive legal requirement of compliance with the *Public Finance Management Act (PFMA)*, 1 of 1999 (RSA 1999) and the *Local Government: Municipal Finance Management Act (MFMA)*, 56 of 2003 (RSA 2003), as minimum requirements in the public sector. The provisions of the *King Report on Governance for South Africa 2009* (IoD 2009) and the associated *Code of Governance Principles (King III)* are specifically intended to be “applied or explained” in all economic sectors, “including the public sector” (IoD 2009). This has raised the question of whether the input, process and output dimensions of a public sector IAF (acting as a corporate governance mechanism) correlate with those of a private sector IAF. This question is especially valid in view of the public sector reforms, which are characterised by the adoption of governance and management frameworks (for example, *King III* and the *2012 Draft Treasury Regulations* in South Africa) whose origins lie in the private sector (Pilcher *et al.* 2013:330; PricewaterhouseCoopers 2010:2).

Thus far, research on public sector internal auditing in South Africa is limited. Two exceptions are an article by Fourie (2007:742), “Financial control measures enhancing good governance”, in which the author argues that internal auditing contributes towards sound financial control measures that should enhance good governance in the South African public sector, and a study entitled “The perceived effectiveness of audit committees in the South African public service” by Van der Nest (2008:180), who shows that the establishment of an audit committee enhances the independence of the IAF in the public sector. A more recent study by Motubatse (2012:484), “Customers’ perceptions of the work performed by the internal audit functions (IAFs) in the public sector: A case of National Treasury”, shows that, with some reservations, internal audit customers perceive the public sector IAF to be



a much-needed management tool that will hopefully be able to improve service delivery in South Africa.

## AIM AND RATIONALE

Starting with the literature available (Carcello *et al.* 2005; Gramling *et al.* 2004; Sarens and De Beelde 2006; Zain and Subramaniam 2007), the 2009 iKUTU research team (Coetzee, Barac, Erasmus, Fourie, Motubatse, Plant, Steyn and Van Staden) performed a comprehensive study of the status of and demand for internal auditing in South African listed companies. The study shows that IAFs can be regarded as playing a significant role in enhancing corporate governance in the selected listed companies (Coetzee *et al.* 2009:73).

A similar study, as reported in this article, was subsequently conducted on South African national departments (National Treasury 2014). This article has two aims. Firstly, it reports on some of the findings from the study on specific corporate governance dimensions of public sector IAFs. Secondly, it compares these dimensions of public sector IAFs to those of private sector entities in order to cast more light on the current state of internal auditing as a corporate governance mechanism in the public sector.

The study on South African listed companies (the private sector) was performed in 2009, while the fieldwork for the study on South African national departments was performed in 2012 (Coetzee *et al.* 2009; National Treasury 2014). This could be regarded as a limitation, but this potential problem is mitigated by the fact that an identical research approach was followed in both studies, that the iKUTU research team performed both studies and that, except for minor adaptations, the same research instruments were used in the 2014 study as in the 2009 study. The comparison made in this article should therefore be considered against this background, and the findings of the study should be interpreted as reporting on the 2012 practices in the public sector by using the 2009 study's findings as the benchmark. This approach is justified by the argument of Judge Mervyn King (the Chairman of the King Committee) that "South African listed companies are regarded by foreign institutional investors as being among the best governed in the world's emerging economies" (IoD 2009:6).

*King III* only became effective from 1 March 2010 and was therefore not applicable for the purposes of the 2009 study. Although some of the *King III* principles are included in the *PFMA* and *MFMA*, the *Draft Treasury Regulations* (National Treasury 2012; RSA 1999, 2003), closely aligned with *King III* on corporate governance matters, was only due to become effective on 1 April 2014 and were therefore not considered for the fieldwork conducted in 2012 for the 2014 public sector study (National Treasury 2014). The exclusion of *King III* from the private sector study (Coetzee *et al.* 2009) and the 2012 *Draft Treasury Regulations* (closely aligned with *King III*) from the public sector study (National Treasury 2014) provides a further reason for using the 2009 study as the benchmark. Since 2009, no other study on internal auditing in the private sector has been performed that identifies the specific internal audit dimensions used in this article.

This article therefore adds to the limited research on public sector internal auditing in South Africa, providing information which can be used by public sector stakeholders to reconsider the role of the IAF as a corporate governance mechanism, which in turn can

bring about enhanced efficacy and efficiency in respect of public sector expenditure (Pilcher *et al.* 2013:331). In addition, the study should benefit the Institute of Internal Auditors (IIA) by providing information from a public sector perspective that can be used to strengthen the role of internal auditor members in the public sector, for example, through guidance documents and training courses.

## LITERATURE REVIEW

The past decade has witnessed a proliferation of corporate governance guidelines and codes, many of which identify internal auditing as a key role player. The literature also supports the view that the IAF is a critical corporate governance mechanism that plays an important role in organisational governance by monitoring organisational risks and assessing controls (Carcello *et al.* 2005:71; Paape *et al.* 2003:261; Sarens 2009:2; Soh and Martinov-Bennie 2011:606).

Private sector entities in South Africa have no legal obligation to conduct internal audits. However, all entities are encouraged to comply with *King III* (IoD 2009). *King III* regards the IAF as an internal assurance provider that contributes to an organisation's combined assurance efforts, and encourages organisations implementing an IAF to follow a risk-based approach to this function (IoD 2009:62,93). Moreover, the Listing Requirements of the Johannesburg Securities Exchange (JSE) require all listed entities to apply the principles in the *Code* and to consider the best practice recommendations in *King III* (JSE 2013).

The concept of governance is well established in the public sector literature, which demands that institutions and their officials function responsibly, transparently and with accountability (Balkaran 2013:122). The importance of internal control in the South African government sector was brought to the fore and re-emphasised with the promulgation in 1999 of the *PFMA*, which requires accounting officers of national and provincial departments to ensure, amongst other things, that effective, efficient and transparent systems of financial and risk management are in place (RSA 1999); section 38(1) points out that internal controls must be functioning and maintained within their departments (RSA 1999). The IAF has become part of these financial management systems, with section 76(4) of the *PFMA*'s requirement that the National Treasury introduce regulations and issue instructions to public institutions' accounting officers to (establish and) maintain an IAF and its activities (RSA 1999); see particularly Treasury Regulation 3.2 (National Treasury 2005).

In 2012, the National Treasury issued a document, the *Public Finance Management Act 1999: Draft Treasury Regulations*, requiring all national departments, constitutional institutions and public entities to have an IAF (National Treasury 2012). In terms of these regulations, the purpose, authority and responsibility of an IAF must, in consultation with the audit committee, be formally defined in an internal audit charter in accordance with the Institute of Internal Auditors' (IIA's) definition, and internal audits must be conducted in accordance with the IIA standards (National Treasury 2012:23). In addition, the IAF must report functionally to the audit committee and administratively to the AO or accounting authority and must act independently, and the IAF is identified as a role player for combined assurance (National Treasury 2012:24). These requirements are closely aligned with *King III* (IoD 2009; National Treasury 2012). At a local government level, section 165 of the *MFMA*

requires each municipality and each municipal entity to have an IAF. These provisions contained in the *PFMA* and the *MFMA* are practical manifestations of the provisions contained in chapter 13, section 216, of the *Constitution of the Republic of South Africa, 1996*, which requires transparency and expenditure control in each sphere of government (RSA 1996).

*King III* applies to all entities, regardless of the manner or form of incorporation, so it includes many of the good governance principles that apply in the public sector legislative framework, such as ethics in governance, as well as the principles of accountability, fairness, transparency and responsibility (IoD 2009). *King III* states that the key responsibility of internal auditing is to aid executive management in discharging its governance responsibilities (IoD 2009:93), and, due to its wide application, this responsibility is shared by the IAFs in both the private and public sectors.

Goodwin (2004:640) maintains that, although internal auditing in the private sector differs from its counterpart in the public sector in terms of the orientation of the framework in which it operates and the scope of its activities, recent reforms in the public sector have reduced differences, especially with regard to governance. These reforms include the adoption of governance and management frameworks that have their origins in the private sector, for example, the *King III* report in South Africa (IoD 2009) and the *Draft Treasury Regulations* (National Treasury 2012). As explained above, South Africa's public sector is governed by a vast number of Acts and Regulations. Moreover, the extent of self-regulation possible, in which an institution voluntarily monitors its own adherence to governance standards, needs to be balanced against these statutory and regulatory requirements (PricewaterhouseCoopers 2010:2). This is in contrast with the voluntary basis for corporate compliance set out in the *King III* report, which allows for an "apply or explain" principle (IoD 2009:6). This approach is justified by *King III* on the basis that flexibility should not be compromised by legislation and that the main focus should not be for companies to be compliance-driven (IoD 2009:5). This is further supported by Turnbull (1997:199), who asserts that self-regulation provides competitive advantages for organisations.

The argument is further made that, due to the rigid regulatory framework in which public sector organisations generally operate, and the *Framework's* emphasis on a service orientation, assigning a lower priority to cost factors and issues associated with profitability, public sector internal auditing needs to have a much broader scope than internal auditing in the private sector, and should therefore include financial-related and performance audits (Goodwin 2004:641). In a similar vein, nearly a decade earlier, Coupland (1993:4) already suggested that public sector internal auditors should broaden their skills and the techniques used well beyond those considered "standard" in the private sector.

The IAF has been described as management's "eyes and ears on the ground" (Reynolds and Aggarwal 2011). In this role, the IAF is well positioned within an organisation to be an integral component of the corporate governance mosaic (Carcello, Hermanson and Ye 2011:8; Gramling *et al.* 2004:196; Soh and Martinov-Bennie 2011:605). Therefore the notion that an IAF provides a credible corporate governance mechanism is well supported in the literature (Eulerich, Theis, Velte and Stiglbauer 2013; Paape *et al.* 2003).

In the current article, it is posited that for the IAF in the public sector to be a credible corporate governance mechanism, some of its dimensions have to be in line with those of an IAF in the private sector, even though the two environments adopt different perspectives.

A recent study by Lenz, Sarens and D'Silva (2013) was used to conceptualise the three dimensions for examination, namely input, process and output.

In line with the prior work by Lenz *et al.* (2013:2), for the input dimension elements, the question of whether the IAF has the right staff with adequate and appropriate skills is considered in the article. The capacity of the IAF as an element of the input dimension is especially relevant where chief audit executives (CAEs) have difficulties in finding people with the right competencies (Allegrini *et al.* 2006:846). This is especially pressing in the South African context, where internal audit skills are considered scarce (Fasset 2012). For the process dimension, the issue of whether the IAF applies appropriate procedures is discussed. Elements considered for the process dimension (to illustrate appropriate procedures of the IAF) are its reporting lines (Coetzee *et al.* 2009:4; IIA 2009; IoD 2009), compliance with standards (IIA 2009), and a consideration of the chairperson of the audit committee's (CAC's) perceptions of IAF operations. For the output dimension, we focused on the usefulness of deliverables (reports and recommendations). Two elements, namely the implementation of IAF recommendations (Mihret and Yismaw 2007:472) and the reliance placed on an internal audit by external auditors (Burton, Emmett, Simon and Wood 2012:152) were considered.

## RESEARCH METHOD

This article draws on primary and secondary data. The primary data were taken from a study performed by the iKUTU research team on South African national government departments in 2012 (National Treasury 2014). An overview of the research method used in the iKUTU study is included in the foreword of this journal, and the method described there was used to obtain the data. The secondary data were taken from a 2009 study conducted by the iKUTU research team on the status of and demand for internal auditing in South African listed companies (Coetzee *et al.* 2009). As the same research team conducted both studies, the initial research instruments – one questionnaire each for selected companies' CAEs, chief financial officers (CFOs) and CACs – were adapted for use in the public sector: CAEs, accounting officers (AOs) and CACs. The questionnaires were updated to reflect the latest developments in auditing and accountability models. For example, the use of the combined assurance model introduced in *King III* was incorporated into the questionnaires for the public sector (IoD 2009). In the 2009 iKUTU study, stakeholders from 30 South African listed companies participated (Coetzee *et al.* 2009), while for the 2012 iKUTU study (National Treasury 2014), the stakeholders of 31 South African national departments responded. The two studies therefore show sufficient similarities to support the comparative analysis undertaken in this article.

## FINDINGS

### Input dimension

The literature supports the notion that an IAF should be adequately staffed (Allegrini *et al.* 2006:846; Lenz *et al.* 2013:2). The profile of the CAE, who sets the tone at the top (Van



**Table 1: Elements of the input dimension**

| Input dimension                    | iKUTU 2012 study:<br>National departments   | iKUTU 2009 study:<br>Listed companies*   |
|------------------------------------|---|--|
| <b>1 Profile of the CAE</b>        |   |  |
| <b>Formal qualifications</b>       | No CAE respondents had a doctoral degree, but 34% held at least a bachelor's degree   | 3.3% of CAEs held doctoral degrees, and 66.7% held at least a bachelor's degree  |
| <b>Professional qualifications</b> | 48% of the respondents had no relevant professional qualifications  | 13.3% of the CAE respondents had no relevant professional qualifications   |
| <b>Experience</b>                  | 14% of the respondents had experience of at least 10 years as a CAE   | 41.4% of the CAE respondents had experience of at least 10 years as a CAE  |
| <b>2 Resources</b>                 |   |  |
| <b>In-house vs outsourced</b>      | Only 3% of the IAF activities were fully outsourced, 28% of IAF activities were done in-house, and the remaining 69% of IAF activities were done through a combination of in-house and outsourced internal auditors | The CAE respondents reported that 36% of their IAF activities were done in-house; the remaining 64% of their IAF activities were either outsourced or co-sourced |
| <b>Adequately staffed</b>          | Only 50.8% of the respondents believed that their IAFs had sufficient resources to operate effectively, and 53.7% claimed that the skillset of their IAFs met their expectations                                    | 80% of the respondents believed that their IAFs had sufficient resources to operate effectively  |

Source: Adapted from Coetzee *et al.* (2009:12–15) and National Treasury (2014:21–24)

Staden and Steyn 2009:919), is considered indicative of the level of competence of an IAF (Nagy and Cenker 2007:43). In this regard, Sarens (2009:4) argues that educational background, previous work experience and professional certification are the profile attributes of internal auditors that affect internal audit quality. Table 1 compares these two elements, namely the profiles of the CAE and the resources available to IAFs based on responses of CAE respondents in the 2012 national department iKUTU study (National Treasury 2014:21-25) and for the iKUTU listed companies study (Coetzee *et al.* 2009).

Table 1 shows that the IAFs for listed companies were in a substantially better position than those in the national departments, based on the profiles of the responding CAEs, in terms of their academic and professional qualifications, as well as experience, and their perceptions of the adequacy of the staff in their IAFs. Moreover, responding national department CAEs rated their current staff component at between 60% and 80% of their ideal staff component. This finding is corroborated by their current co-sourcing and outsourcing practices in relation to the percentage of the work done in-house (compare 36% for the private sector to 28% for the public sector). National department CAEs claimed that the two most important reasons for outsourcing the activities of their IAFs were, firstly, the need for specialised technical expertise and, secondly, a shortage of competent internal auditors. To a lesser extent, these were also perceived to be reasons for outsourcing and co-sourcing of IAF activities by listed company CAEs. Listed company CAEs reported that Big 4 audit firms, which are

generally perceived to be quality audit firms (Lee, Mande and Ortman 2004), were their main outsourcing partners, but for national department CAEs, this was not the case.

**Table 2: Elements of the process dimension**

| Process dimension  | iKUTU 2012 study:<br>National departments  | iKUTU 2009 study:<br>Listed companies  |
|--|--|--|
| <b>1 Reporting lines</b>   |  |  |
| <i>Operationally</i>   | 100% of responding CAEs reported to the AO   | 33.3% of responding CAEs reported to the CFO, 16.7% reported to the CEO, and 3.3% reported to the chief operating officer (COO)  |
| <i>Functionally</i>  | 94% of responding CAEs reported to the CAC   | 83.3% of responding CAEs reported to the CAC, 16.7% of them reported directly to the board of directors (CACs are independent non-executive directors)   |
| <b>2 Compliance with standards</b>   |  |  |
| <i>CAC respondents' perceptions</i>  | 83% of the CAC respondents perceived their IAFs to comply with the IIA Standards   | 90% of the CAC respondents perceived their IAFs to comply with the IIA Standards   |
| <i>CEO/AO respondents' perceptions</i>   | The above percentage dropped to 73%, based on the perceptions of the AO respondents  | The above percentage dropped to 76.7%, based on the perceptions of the CEO respondents   |
| <i>Risk-based approach</i>   | Not included in the 2012 iKUTU study   | The CAE respondents perceived a risk-based audit approach for their IAFs as extremely important (mean = 96%)   |
| <b>3 CAC perceptions of the services provided by their IAFs</b>                |  |  |
| <i>CAC respondents' perceptions on satisfaction (presented as mean scores)</i> | The CAC respondents expressed reasonable levels of satisfaction with the following attributes of their in-house IAFs (mean responses):<br><i>Competency: 62%</i><br><i>Commitment: 71%</i><br><i>Effectiveness of services: 57%</i><br><i>Flexibility: 64%</i> | The CAC respondents expressed high levels of satisfaction with the following attributes of their in-house IAFs (mean responses):<br><i>Competency: 88%</i><br><i>Commitment: 96%</i><br><i>Effectiveness of services: 86%</i><br><i>Flexibility: 84%</i> |
| <i>CAC respondents' perceptions of value added (mean score)</i>                | The CAC respondents expressed a reasonable level of satisfaction with the value added by their in-house IAFs to their organisations – a mean score of 60%.   | The CAC respondents expressed a high level of satisfaction with the value added by their in-house IAFs to their organisations – a mean score of 84%.   |
| <i>Combined assurance model</i>  | The CAC respondents perceived the in-house IAFs to add some value to combined assurance – a mean score of 60%  | Not included in the 2009 iKUTU study   |

Source: Adapted from Coetzee *et al.* (2009:17–19, 37–38,61) and National Treasury (2014:8,13,14,16,17,23)



## Process dimension

Not only are the independence and objectivity of internal auditors paramount when they conduct their duties, but internal auditors should also strive specifically to meet the IIA Standards (IIA 2009). Independence and objectivity are seen as important attributes when determining the quality of the IAF and collectively serve as an indicator of the value added by the IAF (Mihret and Yismaw 2007:480; Fadzil *et al.* 2005:852). The independence and objectivity of the IAF are generally related to or influenced by a CAE's reporting lines: functionally he/she should report to the CAC, and operationally (administratively) to executive management (IIA 2009). *King III* further encourages IAFs to follow a risk-based approach to their duties, and to operate in an entity-wide combined assurance model (IoD 2009).

In Table 2, elements of the process dimension are illustrated for the public and private sector IAFs. These comprise the reporting lines of the IAF, perceptions of compliance with the Standards, and the CAC respondents' perceptions of the quality of their IAF's performance.

It is clear from Table 2 that CAEs from both listed companies and from national departments follow the required reporting lines. The perceptions held by the CACs and CEOs or AOs on their IAFs' compliance with the IIA Standards was similar, and the listed company CAEs perceived a risk-based audit approach to be extremely important. The CACs' perceptions of their IAFs' mastery of specific attributes (competency, commitment, effectiveness of services and flexibility to accommodate management needs) were more favourable for the listed company IAFs than for their national department counterparts. Listed company CACs also recorded a much higher level of satisfaction with regard to the value added by their IAFs than did national department CACs. Overall, it therefore appears that the CACs of listed companies were more satisfied with their IAFs than their national department CAC counterparts. The latter group of respondents also acknowledged that their IAFs added some value as an internal assurance provider within the *King III* combined assurance model, but acknowledged that *King III* does not yet have a significant impact on their national departments' strategies (a mean score of 44%).

## Output dimension

Mihret and Yismaw (2007:472) argue that internal audit findings and recommendations would not serve much purpose unless management is committed to implementing them. Similarly, Burton *et al.* (2012:152) claim the following: "If managers believe that IAFs are ineffective, then IAF recommendations will carry little weight with decision makers." A key element of the output dimension is considered to be the extent of the implementation of IAF recommendations.

Another key element of the output dimension considered in this study is whether external auditors place reliance on the IAF's work. This element is well-researched and documented in the literature by Gramling *et al.* (2004) and Pilcher *et al.* (2013), amongst others. It is worth noting that Burton *et al.* (2012) report that in assurance settings, external auditors prefer to rely on the greater access to technical competencies available to outsourced internal audit functions over the generally greater understanding of the business possessed by in-house internal audit functions.

In the light of the above, Table 3 illustrates the two elements of the output dimension for public and private sector IAFs considered in this study. There were differences in the way these questions were posed in the 2009 and 2012 iKUTU studies. In 2009, respondents were asked to indicate the extent to which listed companies were perceived as implementing the recommendations that were made by their in-house and outsourced IAFs. The question provided four alternatives, namely “always”, “frequently”, “sometimes” and “not applicable” (Coetzee *et al.* 2009:40-41). The 2012 iKUTU study also requested respondents to indicate the extent to which they perceived their national departments as implementing the recommendations of their in-house and outsourced IAFs, but a five-point Likert scale was used, resulting in mean scores (National Treasury 2014:9-10).

A similar situation applies for the question on the reliance placed by external auditors on in-house and outsourced IAFs. (For national departments, the Auditor-General of South Africa fulfils this outsourced role.) The 2009 iKUTU study identified four options, namely “high reliance”, “moderate reliance”, “limited reliance” and “no reliance” (Coetzee *et al.* 2009:41), whereas, for the 2012 iKUTU study, again a five-point Likert scale was used, resulting in mean scores (National Treasury 2014:9), and only the views of the CACs were solicited. The results are therefore not directly comparable, and are simply reported in Table 3.

Table 3 suggests that the perceptions of the national department CACs agreed with the literature in that they viewed the implementation of recommendations made by an outsourced IAF to be higher than those made by in-house IAFs (compare 82.4% with 79.8%). Listed company CACs reported a contrasting view: 32.1% of recommendations made by the in-house IAF were *always* implemented, while for outsourced IAFs this percentage dropped to a mere 19%.

The mean scores recorded for national department AOs and CAEs for the implementation of recommendations made by in-house and outsourced IAFs are similar (compare AOs’ scores of 73.3% and 71.4% for the implementation of recommendations made by in-house and outsourced IAFs respectively with CAEs’ scores of 76.6% and 75% for the same items), while listed company CEOs reported even lower levels of “always” implemented and “frequently” implemented for the outsourced IAF recommendations. One of the reasons could be that the respondents misinterpreted the question (this possibility was also why the question was reformulated for the 2012 iKUTU study). This was deduced from the high percentages of “not applicable” responses recorded by respondents for the outsourced IAF option in the 2009 study.

The results indicate that listed company CACs perceived external auditors to place a higher level of reliance on in-house IAFs than on their outsourced counterparts. A contrasting view was expressed by responding CACs, AOs and CAEs of national departments, who recorded higher mean scores for greater reliance on the outsourced IAFs by the Auditor-General of South Africa. An explanation for this could be the ongoing and severe skills and competency shortages of internal auditors in the public sector alluded to above (see the input dimension). It is equally possible that national department respondents’ perceptions could be based on the argument presented by Burton *et al.* (2012), who claim that outsourced internal auditors are favoured over in-house internal auditors by external auditors, because in-house internal auditors generally have a greater understanding of the business, while outsourced internal auditors have greater access to technical competencies. This finding presents an area for future research.



**Table 3: Elements of the output dimension**

| Output dimension   | iKUTU 2012 study:<br>National departments  | iKUTU 2009 study:<br>Listed companies   |
|--|--|---|
| <b>1 Implementation of the recommendations made by the IAF</b> |  |   |
| <b><i>In-house IAF activities</i></b>                          | Mean scores illustrating the perceptions of the three groups of national department respondents on the extent of the implementation of recommendations by the in-house IAFs:<br>CACs: 79.8%<br>AOs: 73.3%<br>CAEs: 76.6% | Opinions illustrating the perceptions of two groups of listed company respondents on the extent of the implementation of recommendations by the in-house IAFs:<br>CACs: <i>Always 32.1%, Frequently 64.3%, Sometimes 0%, N/A 3.6%</i><br>CEOs: <i>Always 46.4%, Frequently 50.0%, Sometimes 0%, N/A 3.6%</i><br>CAEs: <i>Not questioned</i>                                       |
| <b><i>Outsourced IAF activities</i></b>                        | Mean scores illustrating the perceptions of the three groups of national department respondents on the extent of the implementation of recommendations by the outsourced IAFs:<br>CACs: 82.4%<br>AOs: 71.4%<br>CAEs: 75% | Opinions illustrating the perceptions of the two groups of listed company respondents on the extent of the implementation of recommendations by the outsourced IAFs:<br>CACs:<br><i>Always 19%,<br/>Frequently 42.9%,<br/>Sometimes 9.5%,<br/>N/A 28.6%</i><br>CEOs:<br><i>Always 11.5%,<br/>Frequently 34.6%,<br/>Sometimes 0%,<br/>N/A 53.8%</i><br>CAEs: <i>Not questioned</i> |
| <b>2 Reliance placed on the IAF by the external auditors</b>   |  |   |
| <b><i>In-house IAF activities</i></b>                          | The mean scores of the reliance placed by external auditors (Auditor-General of South Africa) on the work done by the in-house IAFs:<br>CACs: 56.3%<br>AOs: 51.6%<br>CAEs: 61.3%   | Opinions illustrating the perceptions of CACs of listed company respondents on the extent of the reliance placed by external auditors on the work done by the in-house IAF:<br>high reliance 61.5%,<br>moderate reliance 26.9%,<br>limited reliance 11.5%<br>no reliance 0%   |
| <b><i>Outsourced IAF activities</i></b>                        | The mean score of the reliance placed by external auditors (Auditor-General of South Africa) on the work done by the outsourced IAFs:<br>CACs: 55.6%<br>AOs: 66.7%<br>CAEs: 63.5%  | Opinions illustrating the perceptions of CACs of listed company respondents on the extent of the reliance placed by external auditors on the work done by the outsourced IAF:<br>high reliance 41.2%,<br>moderate reliance 11.8%,<br>limited reliance 17.6%<br>no reliance 5.9%   |

Source: Adapted from Coetzee et al. (2009:41-42,46-47) and National Treasury (2014:9-10)

## CONCLUSION

Internal auditing is used in both the private and the public sectors. It is a concept that permeates the literature on governance, but there are still many instances where internal auditing is absent from the real world, or is poorly understood and supported, thus endorsing the appropriateness of a research focus on internal auditing. Using the 2009 iKUTU study (Coetzee *et al.* 2009) on the perceived state of internal auditing in South African listed companies as a secondary data source, and the follow-up research performed by the iKUTU research team (National Treasury 2014) on the state of internal auditing in South African national departments as the primary data source, this article compared specific dimensions (input, output and process) of public and private sector internal auditing. These comparisons focus on IAF dimensions that support internal auditing's role as a corporate governance mechanism and should be considered against the limitations on the study imposed by the time that has elapsed between the two studies. The specific intention of this article was to cast some light on the status and effectiveness of internal auditing as a corporate governance mechanism in the South African public sector. Although governance compliance in the public sector is legislated, the requirements for internal auditing as a corporate governance mechanism in the public sector are aligned with the private sector. This argument is supported by the fact that *King III* is also applicable to the public sector – because the principles set out in *King III* are aligned to those in the *Draft Treasury Regulations*, these principles will effectively be legally required in the public sector once the *Draft Treasury Regulations* are formally adopted (IoD 2009; National Treasury 2012).

The findings of the 2009 iKUTU study that IAFs could be regarded as a significant corporate governance mechanism for selected listed companies (Coetzee *et al.* 2009), were used as the point of departure for this article. The recent study by Lenz *et al.* (2013) was used to conceptualise the three dimensions (input, process and output) that were specifically examined in this article. Elements chosen for each of the three dimensions that represent an IAF's contribution to corporate governance were based on the literature. This article shows that, based on the academic and professional qualifications of CAEs, and their available staffing resources, listed companies' IAFs are still better positioned to contribute positively to the combined assurance efforts of their organisations than are those in the national departments.

The operational and functional reporting lines of IAFs in both sectors meet the profession's requirements. Listed companies' CACs' perceptions of the particular attributes of their IAFs (competency, commitment, effectiveness of services and flexibility to accommodate management needs) were more favourable than those of their national department counterparts. It appears that a higher level of satisfaction was noted with regard to the value added by their IAFs by listed companies' CACs than that perceived by the CACs of national departments. We therefore deduce that the CACs perceived the contribution of listed company IAFs to corporate governance in a more positive light than the national department CACs did.

Contrasting views were reported on the degree of implementation of IAF recommendations. The perceptions of the national department CACs agreed with the literature, in that they viewed the implementation of recommendations made by an outsourced IAF to be more frequently carried out than were those of in-house IAFs, while listed company CACs reported an opposite view. The results indicate that listed company CACs perceived external auditors to place a higher level of reliance on in-house IAFs than on

their outsourced counterparts, while this perception was not shared by the CACs, AOs and CAEs in national departments.

In the light of the above findings, it therefore appears that even though national departments' IAFs are perceived to be valid corporate governance mechanisms, they are not as well established as the listed company IAFs that participated in the 2009 survey. This is an interesting finding, given the fact that for listed companies, governance compliance is voluntary, whereas it is a legal obligation for national departments. Future research could explore whether a legislated basis for governance compliance results in better governance than compliance on a voluntary basis. Such a study could provide useful insights into the most appropriate governance regimes for all entities.

The results of this article should be considered against its limitations. Although the iKUTU research team performed both studies, and used the 2009 questionnaires (with limited changes incorporated to address new developments and specific anomalies), the studies were performed four years apart (in 2009 and 2012). The findings should therefore be interpreted accordingly, by using the 2009 study as a benchmark for comparison.

It is recommended that the role of IAFs as an internal assurance provider in line with the *King III* combined assurance model be further investigated in both sectors, possibly by means of a qualitative study involving CACs, CEOs/AOs and CAEs. The final recommendation for further research is to investigate the motivators of the reliance placed by external auditors on IAFs (internal, outsourced and co-sourced) in the combined assurance model in both sectors.

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