

# Internal controls, governance and audit outcomes

## Case of a South African municipality

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### ABSTRACT

*The inextricable interdependence of internal and external environments of public institutions implies that institutional decisions that are taken by managers have impacts on governance in both directions. This article holds that internal controls enforce transparency and accountability, adherence to legislative requirements, efficiency and effectiveness as well as responsiveness to the needs of beneficiaries. From a literature review perspective, the article argues that research on internal controls enriches the understanding of governance requirements and the ability to distinguish between good and bad. The article is premised on public financial accountability as an area of interest in the discipline of Public Administration; and, it reveals how the assessment of internal controls could influence governance and audit outcomes, using the Roodepoort City Theatre (RCT), trading as Joburg Promusica, case. It examines the general reports of audit outcomes, annual reports and internal audit function reports of the Roodepoort City Theatre (RCT), to corroborate the primary assumption of external control enforcement of good governance.*

### INTRODUCTION

Internal controls are vital in guiding managers and employees about how the tasks should be performed, procedures and methods that should be followed and how to adhere to the established legislation. It requires competent leaders and managers that are skilled in various management functions, such as financial and performance as well as an effective governance by the audit and risk committees. The internal auditors are the key drivers of



internal controls. The drivers of internal controls are responsible for the governance of internal controls. If the internal controls are managed effectively, there is the likelihood that budgets will be spent on areas where they will have the greatest impact and that it will help improve accountability, reduce loss of assets, ensure that accounting records are prepared in a timely and accurate fashion and that financial information is reported reliably. While effectively managed internal controls may also help to improve service delivery and deter undesired outcomes. The absence of internal controls has negative implications on the audit outcomes of public institutions and creates opportunities for the abuse of assets, fraud and corruption (Morehead 2007:1). This is presented annually in the audit reports by the Auditor-General of South Africa (Auditor-General of South Africa 2012a:10), hereafter referred to as the Auditor-General. Therefore, public institutions in general and particularly municipalities and municipal entities, which by nature of their sphere of interaction, are at the forefront of service delivery (cf. Van der Walddt 2006:128).

In South Africa, the research on the influence of the assessment of internal controls on the audit outcomes and governance is mostly conducted by the private sector companies, like Pricewaterhouse Coopers, and it is therefore developed for consulting and commercial purpose, however there is limited research conducted for service delivery purpose. Despite the fact that the private companies and the public sector auditing apply the COSO internal controls framework, the national and internal auditing standards and principles as well as King III governance framework, the public sector institutions are also governed by the South African legislation such as the *Constitution of the Republic of South Africa*, 1996, *Public Audit Act*, (25 of 2004, *Public Finance Management Act*, 1 of 1999 and *Local government: Municipal Finance Management Act*, 56 of 2003 including the *White Paper on Transforming Public Service Delivery*, 1997 also known as the Batho Pele/People First Principles which focuses on the community for which the service is intended.

The major question to be answered is whether the internal controls influence governance in the municipal entities and the audit findings by the Auditor-General. To respond to this question, this article focuses on the general reports of audit outcomes of the Gauteng Province's, Roodepoort City Theatre's (hereafter referred to as RCT) annual reports and internal audit function reports. Thereafter, it presents the concluding remarks and recommends ways through which the internal controls at RCT can be improved and monitored through good governance practices thereby improving the audit outcomes.

## **INTERNAL GOVERNANCE CONTROLS**

Internal controls, as defined by Erasmus & Visser (2011:9); Luyinda, Herselman & Botha (2008:32) and Puttick & Van Esch (1998:162) include the policies, plans, procedures and organisational structures that are designed and adopted by managers in a public institution to provide reasonable assurance that objectives will be achieved and that undesired events will be prevented, detected and corrected. The undesired events emanate from internal and external environments (Ratcliffe & Landes 2009:2). In terms of the *Public Finance Management Act*, 1999 and Draft Treasury Regulations (2012), internal controls help to prevent misuse or damage to assets and protect the confidentiality and integrity of the

information system. As a process or set of actions (Romaniuk 2011:110) or an early warning system (Nombembe 2011:1), internal controls is a means to an end, not an end in itself. It is not used by managers alone, but by employees at every level of a public institution. This process is intended to provide reasonable assurance, not absolute assurance and also to govern the activities of public institutions in order to help them operate effectively and efficiently, particularly to accomplish their performance goals (International Organisation of Supreme Audit Institutions (INTOSAI 2001:5; Committee on Sponsoring Organisations of the Treadway Commission (hereafter referred to as COSO) (1994:5). The objectives of internal controls are to enforce accountability (Morehead 2007:4), create reliable financial reporting, effective and efficient operations and compliance with legislation and regulations (Arens, Elder & Beasley 2008:290) and to improve service delivery (Clamp, Murwira & Kubheka 2012:1).

## Categories of internal controls

In order to achieve good governance, the three interconnected categories of internal controls (COSO 1994:108), that is, effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations (Romaniuk 2011:111) must be aligned to the institutional objectives.

## Effective and Efficient Operations

For public institutions to be able to make ethical decisions they must ensure that they operate effectively and efficiently (Sepsey 2011:416) and managers in these public institutions must regularly check the reliability of internal controls to ensure that it achieves the basic functions for which they were instituted (Gyüre 2012:178) as well as performance objectives (INTOSAI 2007:10). Effective and efficient operations of public institutions refer to the goals of public institutions (Ratcliffe & Landes 2009:3) and avails accurate information for internal decision making (Arens & Loebbecke 2000:289) in order to safeguard assets against loss, misuse and damage (INTOSAI 2007:10). It should however be noted that changes in a public institution and the attitudes of the managers can influence the effectiveness of internal controls and the employees that perform internal controls (INTOSAI 2004:12).

## Reliable Financial Reporting

Financial reporting in the South African public sector is done through the submission of financial statements by the auditees to the Auditor-General. These financial statements are in terms of Section 14 of the *Public Audit Act*, 25 of 2004 audited by the Auditor-General to give assurance (ISSAI 2013:4). In terms of ISSAI (2013:29), the Auditor-General expresses an opinion about the financial statements in a written report. This opinion is based on an assessment of the conclusions that are drawn from the audit evidence that is obtained from the auditee. Whilst auditing the financial statements, the Auditor-General checks whether the financial statements adhere to the financial reporting framework. Standardised financial reporting encourages public institutions to strengthen their internal controls (INTOSAI 2010:23).



## Compliance with Laws and Regulations

Because public institutions are established through the *Constitution of the Republic of South Africa*, 1996, their mandates derive from the legislation. As described by ISSAI (2010:5), compliance refers to the degree to which public institutions obey the laws and regulations, policies, legislation, established codes and standards to which they are subjected. Section 5(1)(c) of the *Municipal Finance Management Act*, 56 of 2003 empowers the National Treasury with powers to enforce compliance with the regulations it establishes in terms of section 216 of the Constitution, 1996. In the sphere of local government, the Treasury may, in terms of Section 5(2)(c), of the *Municipal Finance Management Act*, 2003 monitor and assess compliance by municipalities and municipal entities with any applicable standards of generally recognised accounting practice and uniform expenditure including revenue classification systems. To improve accountability, it is essential for the public institutions to identify and reveal any unlawful, irregular and uneconomical expenses they have incurred due to non-compliance with legislation (AGSA 2014a:8).

## COMPONENTS OF INTERNAL CONTROLS

The five inter-related components are derived from the way in which managers perform their duties and form part of the process of managing activities of public institutions (COSO 1994:4). These components include the following:

### Control Environment

The control environment as defined by INTOSAI (2004:17), provides for discipline, structure and the climate which influences the overall value of internal controls in a public institution. It is a measure of how managers account for the effectiveness and efficiency of internal controls and how it helps achieve the goals of the public institution (DiNapoli 2010:6). Control environment entails the practice of ethical values by employees, their commitment to competence and their own development (Romaniuk 2011:112).

### Risk Assessment

Risk assessment is the process that is undertaken to detect and evaluate risks to ensure that public institutions achieve their objectives (INTOSAI 2004:13). The process is instituted to identify and analyse both the internal as well as the external risks that require urgent attention (INTOSAI 2007:27; AGSA 2014a:4). It helps managers in public institutions to detect and manage the risks that relate to changes in the institutional operation (COSO 1994:4). Managers can assess the risks by making use of either numerical or non-numerical techniques and in order to understand which risks are likely to occur and how they will be managed when they occur (Erasmus & Visser 2011:72). Hence, the designing of internal controls must fit the purpose.

## Control Activities

Control activities may be instituted at different levels of a public institution. The types of control activities that are instituted depend on the type of activities that are performed by employees. Control activities refer to policies and procedures that are used by managers in public institutions to ensure that the directives are diligently adhered to (Ratcliffe & Landes 2009:5). Examples of control activities, as identified by COSO (1994:4), include approvals, authorisation, verifications, reconciliations, performance appraisals, security of assets and segregation of duties. They can either be preventative, detective or corrective depending on how complex the risks may be and a combination of all these can be used (INTOSAI 2004:13).

## Information and Communication

Information and communication (for example, the internal control policies and the risks that the institution is faced with and how these risks must be dealt with) must be communicated to all the employees. Information and communication strengthens internal controls and is important for the day-to-day functioning of a public institution. In an effectively managed public institution, managers and employees must have access to relevant, complete, reliable, correct and timely communication to be able to make informed decisions (INTOSAI 2004:13). Information must be communicated using the established internal communication channels and managers must ensure that such communication is clear, accessible and understandable. In this case, information about internal controls policies, the risks that a public institution is faced with and how it should, however be encouraged that communication flows in both directions, that is, both the top-down and bottom-up approaches are used.

## Monitoring Activities

Monitoring is an important part of the duties that are performed by managers in public institutions. It ensures that internal controls are understood and adhered to. In order to ensure that internal control mechanisms function reliably and that it produces anticipated results, it must be constantly monitored. Monitoring may be in the form of regular supervisory activities and is dependent on the nature of the risks that a public institution is faced with and the conduct or behaviour of employees that perform the duties (COSO 1994:5). When monitoring is designed and implemented effectively, public institutions are able to identify and correct internal controls deficiencies in time (Thornton 2009:2).

## INTERNAL CONTROLS AS MEANS TO GOOD GOVERNANCE

Internal controls enrich the understanding of governance requirements and the ability to distinguish between good and bad governance. The *International Federation of Accountants* (2013:47) defines public sector governance as encompassing the political, economic, administrative, legal measures and other measures that are established to ensure that the outcomes are defined and achieved as planned. It also includes teamwork in policy processes among all stakeholders, including communities (Pillay 2004:587). Good governance is a



not a one-man task, but a role played by all stakeholders who must take into account the community that is affected by the decisions made by those charged with governance. Chapter 12 of the *White Paper on Transforming Public Service Delivery*, 1997 obliges the national and provincial institutions to, through the governance structures, to use the *Batho Pele/ People First* principles as the *watchdog* of how services are provided to the communities. To ensure that the services are delivered effectively to the communities, good governance is a critical consequence. According to the *Institute of Directors in Southern Africa* (2009:6, 9), good governance is about effective leadership and it is interconnected to the compliance with the established laws. The characteristics of good governance, as described by Marx, Van der Watt, Bourne & Hamel (2009:4-5), are transparency, accountability, responsibility and fairness. Clamp *et al.* (2012:1) argue that the lack of a culture of good governance, dishonesty, unethical practices, the lack of skills and the inability by leaders to account, ineffective implementation as well as the lack of monitoring of internal controls are some of the features that characterise the South African public sector. As a result, risks are not managed, fraud is not prevented, thereby leading to ineffective governance (*cf.* Van der Walt, 2010:9). In terms of the requirements of sections 57 of the PFMA and 105 of the MFMA, these managers are the drivers of internal control in that they are, in their respective level of influence and functional areas, held accountable for overseeing internal control activities. Collectively they are accountable for ensuring effective and efficient operations, reliability of financial reporting, compliance with regulations that govern the internal control and maintaining good governance practices. Therefore, Pricewaterhouse Coopers and the Institute of Directors in Southern Africa (2011:6) indicate that the private sector leads in the improvement of governance compared to the public institutions.

## Good Governance through Effective Leadership

The question that arises is whether the leaders of public institutions, and in particular municipalities and municipal entities, actually understand the findings that are made by the Auditor-General. If so, to what extent are they able to resolve the queries that are raised in the audit reports? It is reported in a study that was conducted by Jack (2011:16) that the inability of municipalities to obtain clean audits can be partly ascribed to the incompetence of municipal leadership. All public institutions consist of both the political and administrative leaders who perform different but complementary roles (Craythorne 2003:261). Due to ineffective political and administrative leadership, municipalities in South Africa (*cf.* Oberholzer & Diedricks 2012:2) are faced with human resource management challenges in that they employ candidates that do not have the required skills to perform their jobs effectively. In the context of this study the Board of Directors are the leaders. Therefore, the Board of Directors are accountable for the oversight of internal controls (COSO 1994:7). They are responsible for developing a plan of action that directs the activities of the public institution, mobilise the resources that are required to implement the plan, oversee that the managers and groups of employees understand the plan and that they commit to strive to achieve the goals that are spelt out in it. They also ensure that plans are aligned with all the activities that are performed by managers and employees (Oberholzer & Diedricks 2012:1) and that the roles are clearly defined to avoid duplication (*cf.* De Visser 2010:94) as well as interference, especially in the local government sphere wherein municipalities are controlled politically by

municipal councils and committees then administered by managers and appointed officials (Johnsson 2008:541). In the sphere of local government, the implementation of plans tend to be ineffective due to the lack of skills and the capacity to effectively manage the internal controls. Deficiencies in internal controls are evident in financial and performance reporting and generally, in compliance with laws and regulations (Clamp *et al.* 2012:1).

## **Strategic Role of Managers in the Effectiveness of Internal Controls**

In addition to leadership, effective financial and performance management is required to ensure that the activities that derive from the strategic plans are effectively managed. Senior managers in South Africa's municipalities are assigned the responsibility by Section 77 of the *Municipal Finance Management Act, 2003* to assist the accounting officer (in the context of this article, the CEO) in managing and coordinating the financial administration of the municipalities. Managers are responsible for developing and maintaining internal controls (Arens *et al.* 2008:291). The roles that managers perform to ensure that internal controls are effective including ensuring that relevant and accurate information is kept safely and it is accessible, proper record keeping, supporting financial and performance reporting, the reconciliation of transactions, and compliance monitoring. In order to ensure that employees understand their roles, internal control objectives including procedures, managers must continually communicate internal control policies to them. Although they are entrusted with the responsibility to delegate duties, managers remain accountable and as such have the responsibility to verify that tasks that are delegated are effectively carried out (Erasmus & Visser 2011:18). This means that managers bear the greatest responsibility for the operation of the internal controls in public institutions (Romaniuk 2011:113). Despite holding managers accountable for financial management and performance management, Section 57 of the *Public Finance Management Act, 1999* assigns the responsibility to all public officials to efficiently, effectively, economically and transparently use financial and other resources that are allocated to public institutions. Section 105 of the *Municipal Finance Management Act, 2003* further assigns to all public officials the responsibility to ensure that the systems of financial management and internal controls are always adhered to and that deficiencies are reported to the accounting officer. Managers have the responsibility to institute disciplinary sanctions for serious transgressions by employees, but due to insufficiently skilled managers in South Africa's municipalities, performance management practices and systems are sometimes not instituted (Oberholzer & Diedricks 2012:2), a factor that has a negative influence over their audit outcomes (AGSA 2013a:19).

## **Independent Assurance of the Audit and Risk Committee for Good Governance**

The audit committee, as explained by the New South Wales' Department of Local Government (2008:23), is a committee that provides managers of a public institution with independent reasonable assurance in the areas of internal control measures, risk management, compliance with legislation and financial reporting. As an independent governance entity (*cf.* Fourie 2004:26), it is mandated to resolve any differences of opinion that may exist between the Auditor-General (or any other external auditor appointed by the Auditor-General) and





managers of the auditee (Van der Nest, Thornhill & De Jager 2008:555). This committee must comment on the effectiveness of the internal controls, its evaluation of the Auditor-General's annual financial statements and may communicate any concerns it may have to the Auditor-General, external auditor that is appointed by the Auditor-General and the municipal public accounts committee (MPAC). Reviews of some existing research (*cf.* Van der Nest 2008:185; AGSA 2013b:71), identify most of the audit and risk committees in the South African public sector as ineffective in achieving their mandates. When the audit and risk committee does not achieve its mandate as stipulated by the South African legislation such as the Constitution, 1996, the PFMA 1999 and MFMA 2003, the internal controls will not operate as intended, there will be no accountability and there is likelihood that there will be undetected risks such as fraud and corruption. As indicated by Mthethwa (2013:4), corruption in public institutions is the primary cause of poverty in Africa and this is due to poor governance. Therefore, the independent reasonable assurance provided by the audit and risk committee on the efficiency and effectiveness of internal controls is critical because it enhances the governance within the public institutions, thereby achieving good governance.

### **Internal Auditor Strengthening Controls for Good Governance**

In contrast to the audit and risk committees, internal auditors do not interact with the municipal council, but advise the accounting officer and managers in public institutions. The internal audit sections' knowledge and understanding of the activities of the public institution help in constructing effective relationships, assessing and improving the efficiency of risk management, strength of internal controls, and integrity of the governance processes (INTOSAI 2010:4). Both the audit and risk committees and internal audit sections ensure that the Auditor-General is continually engaged and that managers within public institutions are informed. Some of the roles of the internal audit function are to prepare annual audit plans and internal audit programmes, and to generally examine and contribute to the effectiveness of the internal controls (INTOSAI 2004:43). The role of internal auditors is to advise the accounting officer and to report to the audit committee on the implementation of the internal audit plan. Depending on the decisions that are taken by the public institution, the internal auditors may consist of one or numerous persons who perform routine compliance auditing or diverse responsibilities (Craythorne 2003:243–244). In order to reduce duplication of roles, the internal audit must also co-ordinate with internal and external service providers of assurance (Erasmus & Visser 2011:20). When internal control measures are strengthened, the public institutions are likely to prevent, detect and correct any deficiencies in the internal controls, thereby achieving their goals. Therefore, relationship between the audit and risk committees, internal audit functions and leaders requires to be nurtured and to be based on trust (Oberholzer & Diedricks 2012:2) in order to achieve their goals.

### **Internal Controls Assessment for Clean Audit Outcomes**

As discussed earlier, managers are responsible for designing, implementing and continuously monitoring the effectiveness of internal controls. For internal controls to be effective not only managers are liable but, also the public institution's leadership, governance structures, employees as well as the Auditor-General as the Supreme Audit Institution of South Africa.



The assessment of the internal controls, as explained by Erasmus and Visser (2011:34) and Franca (2014:225), include the review of the risk element, to define the objectives of the internal controls and to evaluate whether they operate reliably and that they comply with the internal and external requirements. The intention of assessing the strength of internal controls (*cf.* Nombembe 2011:1), is not to test or evaluate its operational effectiveness, but to weigh its strength and identify any deficiencies and inaccuracies, to provide managers of a public institution with a formal record that outlines the areas that need attention and the dates at which such deficiencies should have been resolved. An internal control is assessed to understand its strength with regard to financial and performance reporting and compliance (Nombembe 2011:1). As a result of the assessment, internal controls can influence the audit outcomes positively or negatively. The Auditor-General of South Africa assesses the internal controls to determine its strength (Selby 2009:12) against the criteria that is established by the Committee on Sponsoring Organisations of the Treadway Commission (COSO) (DiNapoli 2010:4). Therefore, the assessment of internal controls helps the Auditor-General to evaluate whether they are functional and that the drivers of internal control measures in the public institution manage them effectively. When internal controls are generally inadequate, assets are misused, finances are used fruitlessly, resources are generally wasted and abused, employees perform poorly, records are not kept and as a result, operations become ineffective. Ineffective operations make it impossible for public institutions to achieve their predetermined objectives and to comply with the requirements of legislation. This state of affairs therefore, ultimately makes it impossible for them to obtain clean audit outcomes. However, when they are effectively designed, implemented by qualified and experienced drivers of internal controls and regularly monitored, internal controls provide managers of public institutions with reasonable assurance that unforeseen circumstances will be detected, prevented and corrected. Resources are in this case used sparingly, employee performance and morale improves, operations become efficient and effective and as such, the probability of achieving predetermined objectives and complying with legislation becomes even more likely. Public institutions are in this case able to obtain favourable audit opinions. Effective financial management, systems development, administration and oversight, performance management, monitoring and evaluation, as well as compliance with laws and regulations are factors that help public institutions to obtain clean audits (Oberholzer & Diedricks 2012:1; CoGTA 2011:40).

## **CASE OF ROODEPOORT CITY THEATRE**

The study area on which this article focused is the Roodepoort City Theatre (RCT), trading as Joburg Promusica, established as a Section 21 company in 1981 by the City of Roodepoort (RCT 2009/10-2012/13). RCT was incorporated into the City of Johannesburg Metropolitan Municipality as its municipal entity during the financial year 2004/5. The reason behind selecting RCT as a study area was convenience-based. As a post-apartheid municipal entity, RCT plays a critical role in community engagement and development. The core business of RCT is theatre entertainment and education in arts and culture. Its revenue is derived from multiple sources that include a subsidy from its shareholder—the City of Johannesburg Metropolitan Municipality, sponsorships and donations, investments, event management projects, theatre rentals, bar sales as well as tickets and programme sales. RCT operates



out of a 320 seater auditorium and an 80 seater intimate basement theatre. At the time of conducting the research activities, RCT had merged with the Soweto theatre and consisted of a staff complement of 65 employees that are distributed in different occupational levels and categories (RCT 2012/13:43). In total there were five senior managers (Chief Executive Officer and senior managers of different departments, that is, finance, corporate services, marketing and community development), three middle managers that are professionally qualified in their respective areas of functioning and four junior managers. In addition to senior managers, there were also three middle managers that are professionally qualified in their respective areas of functioning and four technically skilled junior managers. The staff complement also consisted of eight semi-skilled, seven unskilled employees as well as 28 foyer employees and ten tutors. The CEO as the accounting officer, reports to the Board of Directors. Managers in the RCT are supported by the audit and risk committee whose responsibilities include advising the Board of Directors on the functionality of internal controls (RCT 2009/10:26). In addition to the audit committee managers in RCT enjoy the support of the outsourced internal audit function which is responsible for auditors assessing the functionality of the internal controls, monitoring and reviewing the proficiency of the internal control structures and processes and determining whether internal controls comply with the requirements of the legislation. Roodepoort City Theatre's annual financial statements are tabled in accordance to the standards of the generally recognised accounting principles (GRAP) as well as the interpretations, guidelines and directives of the accounting standards board (RCT 2011/2012). In order to adhere to the legislative requirements and as explained in the RCT (2012/2013), managers in the RCT keep a risk register and apply internal controls to detect, prevent and monitor risks. The drivers of internal controls in the RCT, as explained in the RCT (2009/10 to 2012/13), adhere to good corporate governance practices.

## **RESEARCH METHODOLOGY**

This article uses a qualitative, non-empirical research method which in terms of Moody's (2002:1) explanation, explores or analyses historic documents in order to enrich an understanding of whether internal controls influences governance and the audit outcomes at the RCT and in particular, document analysis. The analysis of documents consistently emphasised on gathering primary information on (1) whether the documents are public or private documents; (2) the uniqueness of the documents (whether the documents are annual reports, audit reports, internal audit reports or legislation); (3) date the documents were created/ approved/ commenced; (4) author of the documents and the position of the author; (5) intended audience of the documents; (6) purpose of the documents; (7) context in which the documents were written; (8) significance of the documents to this study; and (9), main points that are expressed by the documents in relation to the governance of internal controls. Targeted documents that were analysed were RCT's annual reports published by the Auditor-General of South Africa as well as the RCT's annual reports and RCT's internal audit function reports. The underlying reason underpinning the choice of (1) general reports of audit outcomes of Gauteng Province local government (2) RCT annual reports and (3) RCT's internal audit function reports is that they report on the role of governance in the design, implementation and monitoring of internal controls. Whilst selecting these documents, a

purposive and convenience sampling procedure, augmented by the use of a checklist whose intention was to authenticate whether these reports were timely (between 2008/09 and 2012/13 financial years), relevant (contained information about the internal controls and the drivers of internal controls of RCT), authentic (uniqueness of the document, type of target audience for which the document was created and the name of author of the document) and credible (context in which the document was written, significance of the document and the main points that are expressed in the document). In total 30 documents were targeted for analysis. That is, five general reports of audit outcomes of Gauteng Province local government, five RCT's annual reports and twenty 20 RCT's internal audit function reports would be analysed. Internal audit function reports are created on a quarterly basis and therefore in total, four internal audit reports that are created annually were multiplied by the number of five financial years. Three main points that are expressed in the general reports of audit outcomes of Gauteng Province local government are about the (a) assessment of the strength of internal controls (b) assessment of the effectiveness of RCT's drivers of internal controls; (c) root causes of the audit findings on the internal controls. In contrast to the analysis of the general reports of audit outcomes of Gauteng Province local government, the RCT annual reports expresses themselves in two main points about the (a) the assessment of the strength of internal controls and (b) the drivers of internal controls whilst the internal audit function reports on four main points that are about the (a) assessment of the effectiveness of internal controls and the risk rating; (b) deviations from the internal controls; (c) root causes from the deviations on the internal controls; and (d) implementation status of the corrective measures put in place. Limiting factors were experienced, especially during the stage at which the data was gathered. Due to changes in management, especially before the merger, it became difficult to trace the 2008/09 annual report and the internal audit function reports for the 2008/09, 2009/10, 2010/11 and 2012/13 financial years. In total 16 internal audit function reports could not be accessed. In order to substitute these 16 missing internal audit function reports, alternative reports that were created by the internal audit function were utilised, that is, one internal audit function follow-up report (13 August 2012), four performance information review reports (21 November 2011, 27 February 2012, 10 May 2012 and 13 August 2012), two progress reports to the audit and risk committee (4 May and 13 August 2012) as well as one (1) internal audit report to the audit and risk committee (15 March 2012). Moreover, since RCT obtained a clean audit during 2009/10 financial year, then, four internal audit function quarterly reports for the financial year 2009/10 will be considered as effective and added as part of the substituted reports. These documents were relevant in that they reported about the 2009/10 and 2010/11 financial years' internal controls review findings and the comparison of findings on the auditable areas for 2010/11 and 2011/12 financial years. In total, 12 of the 16 missing internal audit reports were substituted and as a result, 25 of the 30 targeted documents were analysed.

## RESULTS OF THE CASE STUDY

Generally, the performance of the RCT's drivers of internal controls was found to be ineffective. Also, as a result of the inefficiency of senior managers, the records management system was ineffective, deviations from internal controls increased, the root causes of



deviations were not attended to, corrective measures that were proposed by the audit committee and internal audit function were not adequately implemented and in general there was non-compliance to the law and regulations. Although the ineffectiveness of senior managers can be blamed on vacant key positions, some of it can be directed to the Board as it is the Board's responsibility to ensure that vacant senior managers' positions are filled. The audit and risk committee's performance between the 2009/10 and 2012/3 financial years was effective whilst the performance of the internal audit function was ineffective and this may be due to the fact that it was not internal *per se*, but outsourced to private service providers. As such, members of the outsourced internal audit function were not available on a daily basis to observe whether internal controls policies are adhered to or advise senior managers on pertinent internal controls issues. Seemingly, a contractual agreement entered into between the parties did not make provision for the party that will be held liable for records management; hence most of the internal audit function reports could not be retrieved.

## RECOMMENDATIONS

As a way of ensuring that the Board performs effectively in its key leadership areas, the shareholder or parent municipality must institute appropriate measures to ensure that the Board is stable. The best way of achieving a stable Board is to introduce a retention strategy through which loyal and experienced Board members are capacitated to perform their duties effectively. Additionally, market-related emoluments must be determined from time to time to compensate Board members for their contribution to the functioning of the RCT. For vacant senior positions, it is recommended that a human resource management committee of the Board be mandated to fill vacant senior managers' positions as soon as they become vacant. After all the vacant senior management positions have been filled, this committee has to ensure that senior managers in key positions are trained in their respective areas of functioning and that they are also retained. The performance of senior managers in designing, implementing and monitoring of internal controls needs to be regularly monitored by the human resource committee. Where possible, a key performance area against which the performance of senior managers' on internal controls will be assessed must be contained in the performance contracts and penalties enforced if there is failure. Opportunities for training senior managers on the design, implementation and monitoring and in general, developments in the field of internal controls, must continually be explored. For senior managers to be effective in maintaining effective internal controls, they rely on the audit and risk committee and the internal audit function. To be able to overcome the challenges that emanate from the ineffectiveness of the internal audit function, the CEO has to review the contractual agreement entered into with the private service provider. Part of this contractual review should be about skills transfer to build internal capacity to establish a properly constituted internal audit function. The contractual agreement into which the parties enter must specify the timeframe during which the transfer of skills will be concluded. The RCT's internal audit function would best be positioned to continually attend to monitor deviations from internal controls and to assist managers to implement corrective measures. These recommendations, if they are instituted by the governance structures within the municipalities and municipal entities, would improve the strength of the RCT's internal

controls and therefore the efficiency and effectiveness of operations, reliability of financial reporting, compliance with the law and regulations and as a result the RCT's audit findings and audit trajectory.

## CONCLUSION

This article argued that the assessment of internal controls influences governance and the audit outcomes at RCT. The findings from an analysis of the documents reveal critical areas on which corrective measures must be instituted to improve the RCT's audit trajectory. However, the most significant area on which emphasis should be made is the role of senior managers as part of the drivers of internal controls. Reasons that justify the need for such an emphasis are that, senior managers are empowered by legislation to develop and maintain effective internal controls. Also, the relations among the internal controls, the audit outcomes and the assessment of internal controls have significant influence on the governance as well as good governance. If the governance structures of internal controls do not perform their stipulated tasks efficiently and effectively, it impacts on the overall performance of the internal controls thereby negatively influencing the audit outcomes. As a way forward, Section 165 of the *Municipal Finance Management Act, 2003*, in terms of which the internal audit function can be outsourced to private service providers, needs to be reviewed. The result of this review must state whether a private service provider assumes public employment or not and whether it becomes an internal audit section of the municipal entity or not, otherwise an outsourced internal audit function will operate exactly like the audit and risk committee that consists of independent external auditors.

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