

AUDIT COMMITTEES AND ACCOUNTABILITY IN THE SOUTH AFRICAN PUBLIC SECTOR

D. P. van der Nest
Department of Auditing
Tshwane University of Technology

C. Thornhill
School of Public Management and Administration
University of Pretoria

J. de Jager
Research Professor
Tshwane University of Technology

ABSTRACT

It is argued in this article that audit committees are key contributors to improved corporate governance in the public sector. Management in the public sector is increasingly required to ensure that an effective system of internal control and sound governance is applied in their responsibility areas. Increased accountability is a requisite for a good democracy and for improved service delivery. The audit committee is a legislated accountability instrument in the public sector and it is argued that if these committees function effectively they will contribute to improved corporate governance. When measuring the perceived effectiveness of audit committees in national government departments from an external audit perspective, areas for improvement of these committees are identified. This provides an indication of how successful the public sector has been in implementing this *Public Finance Management Act, 1999* (Act 1 of 1999) requirement.

INTRODUCTION

Since the inception of the *Public Finance Management Act, 1999* (PFMA) (Act 1 of 1999), strict measures to implement the principles of good corporate governance and control had to be implemented by managers at all levels in the public sector. Managers had to integrate the added responsibility of ensuring that there is a sound system

of control in the area of their responsibilities with their operational activities. Improved financial management forms the cornerstone of improved service delivery and outputs in the public sector.

There is increasing pressure on public officials to demonstrate a high level of accountability concerning the use of public funds. These accountability requirements and the requirement for sound financial management have brought public sector managers in contact with accountability instruments such as internal audit and the audit committee of the institution. This study provides a review of accountability in the public sector, it investigates audit committees as an accountability instrument. The study provides an independent opinion on the effectiveness of audit committees in improving corporate governance in the national government departments from an external audit perspective.

DEMOCRATIC ACCOUNTABILITY

Accountable government in the public sector is an indispensable pre-requisite for a democratic dispensation (Cloete, 1996:xi). Public sector institutions are, universally, faced with the issues of ethical and transparent administration and implementing good corporate governance (Mbatha, 2002:1). Accountable government implies accountability as a key ingredient of the quality of a democracy and the long-term viability thereof (Schedler, 1999:2). Schedler maintains that in new democracies, the deficiencies of accountability are often more visible, dramatic and urgent, as in the case of South Africa, than in long-established democracies. It does, however not imply that accountability deficiencies are limited to new democracies, it is a universal occurrence. As the focus on good (and bad) governance in South Africa and internationally increases the citizens of a country will benefit from more favourable perceptions and improved relationships with the public (Mbatha, 2002:19).

CONCEPTUALISING ACCOUNTABILITY

Accountability is an important yet elusive concept, the meaning and characteristics will differ depending upon the context where it is applied (United States General Accounting Office, cited in Behn, 2001:3). This gives an indication of the difficulty of defining accountability and the extent to which an "accountability holder" can be held accountable. The general notion of accountability is embedded in the tradition and history of a government. In a broad sense, the accountability environment in government should include the explicit political will that will constrain government officials' conduct and actions in a well defined system of oversight (Kearns, 1996:12). In its most narrow interpretation Kearns states that accountability involves answering to a higher authority in the bureaucratic system of oversight (Kearns, 1996:7). According to Lord (2004:130), if *representative* is to stand in for citizens, to be accountable is to owe them *accounts* or justifications on the basis of which office holders may be rewarded or acted against.

In a democracy, it is accepted that the citizens will decide on the structure of public institutions and the activities performed by them, through their elected representatives. The citizens expect public institutions and the officials that they employ to promote the general welfare of the people of the country (Cloete, 1996:18). According to this view the ultimate accountability will have to be enforced by the citizens of the country on the institutions that have been established by them through their representatives (and the democratic system). According to Stapenhurst *et al.*, (2005:2) the legislature in a country has three functions - representative, legislative and oversight. The functions of the legislator represent the will of the people, the people being the originating legislative source of authority in democratic countries. People's representatives perform legislative functions in introducing, approving, amending or rejecting legislation. They perform an oversight role in the preparation of a policy and the execution thereof.

ACCOUNTABILITY IN THE SOUTH AFRICAN PUBLIC SECTOR

Accountability in South Africa has its origin in the *Constitution of the Republic of South Africa*, 1996 as seen in paragraph 2.2.1 (v) above. Cloete (1996:23) states that with the inception of the Constitution of South Africa was accepted as a democratic state. This implies that universal suffrage has been put in place. By implication, all the activities of the legislative, governmental, administrative and judicial systems and functionaries in all spheres of government are subject to surveillance by the citizens. Cloete (1996:23) stresses that accountability in the South African public sector is not merely a matter of control, which is a function performed to obtain accountability. Every public institution and functionary is held responsible to implement accountability measures. If an institution is authorised or instructed to perform a function it is obvious that the institution delegating the power will have to put surveillance measures in place to ensure that the instructions are obeyed and implemented.

Although financial accountability is not the only form of accountability, it plays a significant role in public accountability. Financial accountability in South Africa originates from the Constitution, 1996. Individual accountability is a requirement for collective accountability, in that individuals are held accountable for carrying out their assigned duties, which may assist in the collective accountability procedures (Mulgan, 2003:24). According to Schedler (1999:10) a large-scale organisation, such as a government department, is structured organisationally as a hierarchical pyramid. The task of ensuring the implementation of accountability functions on behalf of the organisation usually rests with those placed in charge.

In the South African public sector the division of accountability is evident from the *Public Finance Management Act*, 1999 (Act 1 of 1999). Accountability among public officials/administrators starts with the accounting officer of a government department. The accounting officer mentioned in section 36 of the Act is assigned accountability requirements by section 38 of the *Public Finance Management Act*, 1999. These include responsibilities to ensure that the department has and maintains a system of financial and risk management and internal control. This system of internal control must be monitored

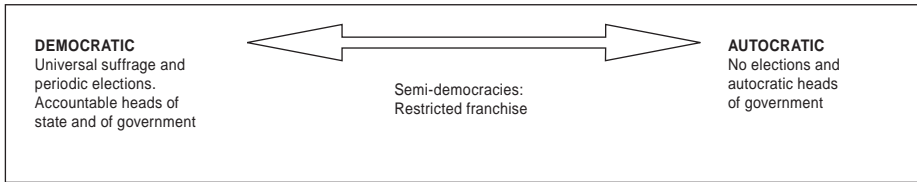
by an internal audit function, under the control and direction of an audit committee. It can be seen that the audit committee has been built into the legislative framework as an accountability instrument.

DEMOCRACY AND ACCOUNTABILITY

What is a good democracy? According to Mostafa and Younis (2000: xii), in an effective democracy the people are the source of all power. However, Jain (cited in Mostafa and Younis, 2000:xiii) mentions the fact that bureaucracies (public institutions) have become powerful political actors. These public institutions may use this power in ways that deviate from the defined collective democratic benefit. Morlino (2004:12) describes a good democracy as a stable institutional structure that realises the liberty and equality of citizens through the legitimate and correct functioning of its institutions and mechanisms. A good democracy is thus a broadly legitimated regime that satisfies its citizens in terms of results.

According to Cloete (1996:20) nations can be placed on a continuum from democratic to autocratic:

Table 1 Democratic and Autocratic Government



All political systems need devices to hold individuals in public and private sectors accountable for their actions. A political system depends on a combination of control *ex ante* (in the preparation stage) and accountability *ex post* (oversee the implementation stage). In modern democracies people should be held accountable if they are demonstrably incompetent or dishonest.

Audit committees as an accountability instrument

National Treasury (2001:2) cites audit committees as being an integral part of the process of transparency, accountability and improved financial management. This is the reason why audit committees have become a legislative requirement for government. In terms of the *Public Finance Management Act*, 1999 audit committees are compulsory for national and provincial government departments, as well as for public entities under the control of government. Expanded accountability extends to the sphere of local government, audit committees have become a legal requirement for all municipalities in terms of the *Local Government: Municipal Finance Management Act*, 2003 (Act 56 of 2003).

Table 1: Key audit committee responsibilities

Assessing the Risk & Control Environment	Overseeing Financial Reporting	Evaluating the Audit Process
Control Environment	Earnings Releases	Internal Audit Mission
Risk Assessment	Financial Reports	Independent Audit Expectations
Control Activities	Committee Diligence	Collaboration and Communication
Information and Communication	Committee Assessment	Understanding Results and Conclusions

Audit committee functioning and responsibilities

The audit committee is seen as an important mechanism in corporate governance. The focus on service delivery and accountability in the public sector has increased the focus on good corporate governance. Audit quality and the integrity of financial reports as well as the quality of the system of internal control in an entity necessitate an independent audit committee that acts as a link between management, internal and external audit. According to Briarotta (2004: xv) the mandate of members of audit committees requires of them to adhere to higher quality standards in corporate accountability to ensure the quality of financial information and of both the internal and external audit processes.

Governance in the public sector deserves the same attention as governance in the private sector. Therefore it could be argued that audit committees in the public sector have similar responsibilities as their counterparts in the private sector. Whereas unethical behaviour in the corporate sector impacts on the shareholders of a company, unethical behaviour in the public sector impacts on all taxpayers and citizens of a country.

Functions of an audit committee

The most effective audit committees are not only critically aware of their responsibilities, but also completely understand and embrace them, and recognise what is necessary to fulfill them effectively (KPMG, 2006:12). The work of the audit committee has evolved in response to changes in the business environment and managerial practices.

KPMG (2006:12) classifies the responsibilities of the audit committee under three key areas of responsibility: (KPMG 2006:12)

The key areas identified in Table 1 above will be expanded on in the following section:

Assessing the risk and control environment

Risk management involves identifying risks that may prevent a department from achieving its objectives, analysing those risks, avoiding certain risks and managing those that remain. According to Walker (2004:181) recent guidelines suggest that audit committees should fulfill the role of assisting to assess risks facing the government department. As it is a management responsibility, Walker indicates that audit committees should limit their involvement in risk assessment to a forum where risks (and the management thereof) are assessed. Keinath and Walo (2004:24) state that risk assessment, and risk management have been of particular concern since the Enron scandal. Audit committees must understand the organisation and be aware of the risks that may be threats to it. An audit committee comprising of independent and knowledgeable members is in a good position to pose the right questions to determine whether the company, or department, is managing risk adequately. KPMG (2006:13) states that the audit committee members should ask probing questions about risk management and understanding how the organisation manages risk. The audit committee can then help to bring clarity to the process used to manage risk and the assignment of responsibilities/accountabilities to monitor and react to changes in the organisation's risk profile.

In terms of the system of internal control the audit committee also has specific responsibilities. According to the *National Treasury* (2001:13), the audit committee is responsible for the evaluation of the procedures implemented by management in order to address internal control issues as identified through the risk management process and in audit reports. It must be given assurance that the accounting and information systems and related controls are adequate and effective.

Overseeing financial reporting

The audit committee's responsibilities typically include assisting management by overseeing all financial reporting to ensure that it provides accurate and useful information to users. *The King Report* (2002) states that the audit committee must assist the board (management, in the public sector context) to discharge its duties with regard to the preparation of accurate financial statements in compliance with all applicable regulations, legislation and applicable accounting standards. When the audit committee reviews financial statements that they must focus on specific issues such as materiality, compliance with accounting policies, significant changes and areas susceptible for fraud (PWC, 2006:3).

According to Terrell and Zanni (2002:54) monitoring of the financial reporting process in an organisation reviews activities in the area of responsibilities of the Chief Financial Officer (CFO). CFOs should be prepared to respond to the expectations that audit committees will place on sound financial management and the quality of financial reporting of the organisation. Open dialogue between the CFO and the audit committee is imperative in order for them to meet each other's expectations.

Evaluating the audit process

A key responsibility of the audit committee is to evaluate the audit process in the organisation. The process followed by both external and internal audit must be evaluated for effectiveness and value adding.

In terms of their relationship with the external auditors Briarotta (2004:83) states that both the audit committee and external audit share an objective regarding the financial affairs of the organisation. The audit committee oversees the audit and receives the findings and recommendations from external audit. In the private sector the audit committee is involved in the appointment of external auditors for the company and the committee makes the recommendations of whom should be appointed. In the public sector the mandate of external audit is normally governed by legislation (*Public Audit Act, Act 25 of 2004*), and the audit committee is only involved in overseeing the actual audit and receiving the findings.

In terms of the audit committee's relationship with internal audit Meyers and Ziegenfuss (2006:53) emphasize the importance of the audit committee having an open line of communication with the chief audit executive. The audit committee should meet with the chief audit executive on a quarterly basis. Topics to be discussed include internal audit operations, organisation's control environment and internal audit findings. The audit committee must be satisfied that the reporting lines of internal audit reflect its organisational independence and objectivity (PWC, 2006:37). Key to this requirement is that the chief audit executive reports administratively to the accounting officer and functionally to the audit committee.

The audit committee should ensure that internal audit operates effectively. To do this, they should evaluate the chief audit executive and also evaluate the whole internal audit function of the organisation.

Public sector audit committees

The audit committee is an integral element of public accountability and governance. It plays a key role in respect of the integrity financial reporting of the government department (George, 2005:43). According to the National Office of Audit and Accounting (2002:2) the nature of a public sector audit committee will differ from general corporate audit committees because of the nature of oversight over government and the way it is funded. Public sector audit committee members face special challenges because of the uniqueness of public sector entities. Although the functions of the audit committee are relatively generic, certain adaptations of the functions need to take the unique nature of the public sector into consideration. With a worldwide increased regulatory interest in the accountability benefits of audit committees (Abbot *et al.*, 2003:17), it could be argued that emphasis on accountability in the government environment will increase the importance of the role of public sector audit committees. If the audit committee of a department operates effectively, it can significantly increase both the integrity and effectiveness of the system of internal control, financial reporting and the audit process.

Audit committee effectiveness

Cohen, Krishnamoorthy and Wright (2002:56) define an efficacious audit committee, as a committee that is not influenced by management and that understands the financial reporting processes of the organisation. De Zoort *et al.*, (2002:40) identify the following four determinants of audit committee effectiveness:

- *Composition*: expertise, independence, integrity and objectivity
- *Authority*: responsibilities and influence on management and auditors
- *Resources*: adequate number of members, access to management, external auditors and internal auditors
- *Diligence*: incentive, motivation and perseverance

It is clear that the above-mentioned authors place major emphasis on membership of the committees. Sufficient number of members, quality, expertise as well as the authority and support from management will have an effect on the performance of audit committees in the South African public sector.

Bedard, Gendron and Gosselin (2004) evaluate the effectiveness of audit committees in three corporations using the following measurement criteria:

- audit committee composition
- audit committee authority
- audit committee resources
- audit committee diligence
- background of audit committee members
- quality of audit committee documentation
- matters emphasised in audit committee meetings
 - financial statements
 - effectiveness of internal control
 - evaluation of internal and external audit.

These are key quality elements that will influence the functioning and effectiveness of any audit committee. There is again a major emphasis on member quality but they also identify three key responsibility areas, namely financial reporting, internal control and the evaluation of the audit process.

Benefits of an Effective Audit Committee

Particular benefits will accrue to the organisation if the audit committee functions effectively. National Treasury (2001:14) lists the following benefits of an effective audit committee:

- ensuring an independent internal audit function, which operates efficiently and effectively, is ensured;
- risk management practices are applied in the organisation;
- sound corporate governance practices are applied;

- the system of internal control is adequate and functioning effectively; and
- fraud and corruption is being dealt with effectively.

Psaros and Seamer (2004:77) indicate that several advantages result from an effective audit committee. It ensures the quality of financial reporting, facilitates the independence of external auditors, aids management in meeting their legal responsibilities and improves the quality of accounting and internal control systems.

Effectiveness assessment

Notwithstanding the virtues of audit committees and the existence of legislation for their establishment, there remains the overriding question of their effect on organisational accountability in the public sector. The perceived effectiveness of audit committees in the national government departments was measured from the perspective of staff from the Auditor-General.

Perceived effectiveness of audit committees was measured in terms of five key performance areas as identified in the literature research. These functions are, however, also a legal requirement required by the Treasury Regulations.

To determine the perceived effectiveness of the committees a number of semi structured interviews were conducted with senior staff members (Business Executives) from the Auditor-General. They were, in addition to open-ended questions, requested to provide an effectiveness rating from 1-5, on a Likert-type scale of the key functions that audit committees should perform. The business executives interviewed attend, between them, 24 of the national departments' audit committees.

The first key finding that has been deduced from the responses from all the interviewees, is that there are major differences in the quality and effectiveness of audit committees among departments. Some national departments have model audit committees that comply with all best-practice requirements and function effectively, whilst a number of departments have ineffective audit committees that do not contribute to improved corporate governance in the departments.

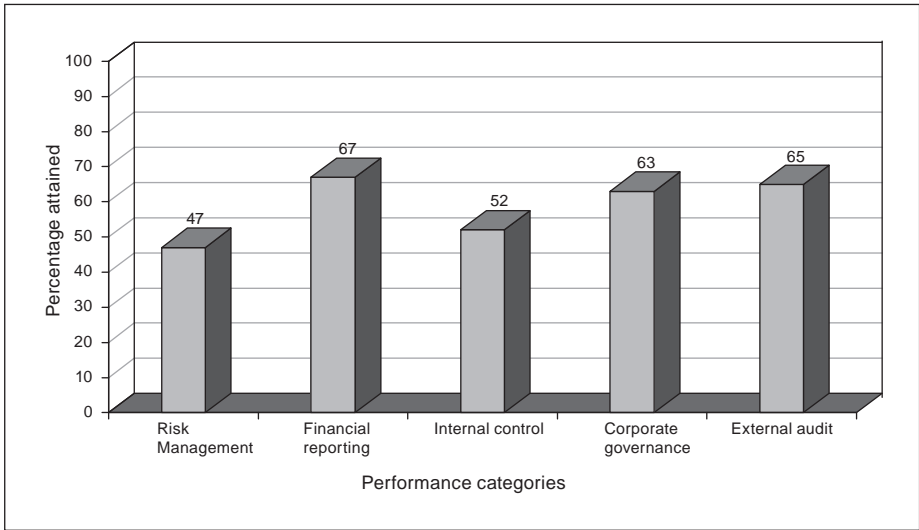
One interviewee indicated that 38% (three) of the 8 audit committees she is involved in, are functioning effectively, 25 % (two) of the committees are average and 38% (three) of the committees do not function effectively in terms of the required responsibilities and best practice. Indications are that a limited number of audit committees are almost dysfunctional.

The areas of responsibilities against which the audit committees were measured are:

- risk management
- financial reporting
- internal control environment
- corporate governance and effective oversight
- external audit.

An assessment of the perceived effectiveness of audit committees in terms of each of the core responsibilities yielded the following percentages:

Figure 1 Effectiveness assessments: Auditor-General



The details regarding all the assessment criteria in figure 1 are discussed below.

Risk management

The audit committee is required to assess management’s risk management processes and internal audit and external audit’s coverage of these risks (SA 2005:8). Interviewees rated the perceived effectiveness of the audit committee’s risk monitoring processes at 47%. This provided an indication that there is a perception that there could be a substantial improvement in the audit committee’s discharge of its duty regarding the monitoring of risk management processes in the departments.

It is appropriate to consider the performance of audit committees in the oversight of risk management processes in government departments, as risk management is a key requirement of the PFMA and the Treasury Regulations. This research provides evidence that South African public sector audit committees need to improve their strategies and procedures regarding the monitoring of key strategic and financial risks of departments.

Financial reporting and compliance

The perceived effectiveness of audit committees regarding their oversight over the financial reporting process of departments was rated at an average of 67%. The audit committee must evaluate management’s financial reporting and compliance procedures. The audit committee should receive quarterly financial reports and explanations for any over/under expenditure. To improve the perceived effectiveness of audit committees with regard to financial reporting, audit committee members should be informed of any changes in Generally Accepted Accounting Practice, as well as the changes to National Treasury financial reporting and budget frameworks.

The internal control environment

It is argued that audit committees should be responsible for overseeing management's assessment of risk. The audit committee can strengthen management's ability to identify and assess both internal and external risks (Turley 2001:12), as well as their implementation of appropriate controls to mitigate these risks. It is recognised that the audit committee can strengthen internal audit in the department as a monitoring mechanism to assess the effectiveness of these controls (National Office of Audit and Accounting 2002:4).

A key source of information with regard to the effectiveness of the system of internal control is the internal audit section in the department. The effectiveness of internal audit will have an influence on the quality of information the audit committee receives on the internal control structure of the department. The effectiveness of the support for internal audit and follow-ups on internal audit reporting as well as support for internal audit in terms of budget and staffing will thus be a key function of the audit committee.

The perceived effectiveness was rated at an average of 52%. As a result of the importance of this factor, this is an area in which audit committees should improve on their involvement in the internal audit function. It is a legal imperative to be involved in the internal process and the low perceived effectiveness implies that a need for an improvement in the capacity or ability to meet these requirements exists.

Corporate governance and effective oversight

The responsibilities of audit committee members include the requirement to contribute to an improvement in the corporate governance of the organisation (Levy 1993:60). The fourth area of potential impact of the audit committee to be measured in this research is the perceived effectiveness of the audit committee in improving corporate governance and oversight in the government department. The overall evaluation of the performance of the committee in its contribution to corporate governance, as was assessed by interviewees, was rated at an average of 63%. The interviewees expressed the opinion that audit committees are contributing substantially to the improvement of corporate governance in departments.

Relationship with external audit

The audit committee must support the external audit function, through the Auditor-General, in its independence, communication with management and evaluation of key findings in the management letter issued to a department by the Auditor-General on the audit findings and evaluating responses. The audit committee has to resolve any differences in opinion between the external auditor and management.

In the above table an average perceived effectiveness of 65% was measured with regard to the support the audit committee provided to external audit. In the interviews, it was mentioned that there could be an improvement in the follow-up of management's actions based on the findings of the Auditor-General. Although most departments develop action plans to address the issues identified during the audit, the same findings recurred in successive years. During the interviews it emerged that the audit committee

tended to side with management in trying to remove possible negative remarks from the audit report. This could be ascribed to the fact that the audit committees wanted to be considered as being effective in addressing audit issues and improving the control system in the department.

CONCLUSION

This research has demonstrated that there is, to a large extent compliance with legal requirements regarding audit committees, as well as best practice requirements. It has shown that a substantial number of audit committees function as model audit committees in the respective national departments. It is, however, disturbing to find eight years after implementation of audit committees, some audit committees are not functioning effectively and are not making the required contribution to improved corporate governance and accountability. The majority of audit committees are not seen as ineffective, but there are areas for the improvement of their operations. The areas of focus should be:

- Attendance of accounting officers at all audit committee meetings, should be made mandatory.
- With regard to chairpersons and members, departments should ensure that their recruitment processes identify persons who possess the knowledge, experience and competence to provide a meaningful contribution to the committee to serve on the committee.
- With regard to members' remuneration, an investigation should be conducted to establish whether the remuneration paid to members is market related and sufficient to attract competent, experienced members and chairpersons to public sector audit committees.
- A key finding of the research was that an effectiveness assessment of audit committees was, in general, not performed in departments. The recommendation is that an audit committee self-assessment exercise be done for the audit committee bi-annually.
- Parliament should recognise the importance of audit committees as an accountability instrument in departments and focus on their effectiveness as this could provide them with an independent opinion regarding the risk management, financial reporting and control environment in departments.
- Risk management should be a standing item on all audit committee agendas. The audit committee should ensure that the department has a risk assessment carried out and that the risk assessment is updated annually.
- A recommendation with regard to the monitoring of internal audit is that a process should be developed by audit committees to evaluate internal audits' compliance with the Standards for the Professional Practice of Internal Auditing as developed by the IIA.

The emphasis on improved corporate governance, control frameworks and financial management will place the onus on audit committees to act as an accountability

instrument in departments. Therefore it is crucial that accounting officers, Treasury and policy makers appreciate the value of effective audit committees as accountability instruments and that their actions should be directed towards strengthening these committees and monitoring their effectiveness, this will then contribute towards improved accountability in the public sector.

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