

INTERNAL AUDIT RISK MANAGEMENT IN METROPOLITAN MUNICIPALITIES

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Abstract

Internal audit functions (IAFs) of organisations are regarded as crucial components of the combined assurance model, alongside the audit committee, management and external auditors. The combined assurance model aims at having integrated and aligned assurance in organisations with the overall aim of maximising risk and governance oversight and control efficiencies. In this regard, internal audit plays a crucial role, insofar as it consists of experts in risk, governance and control consultancy who provide assurance to senior management and the audit committee. Audit committees are dependent on internal audit for information and their effectiveness revolves around a strong and well-resourced internal audit function which is able to aid audit committees to meet their oversight responsibilities. There is thus a growing demand for managing risk through the process of risk management and internal audit is in a perfect position to assist with the improvement of such processes. If internal auditors wish to continue being an important aspect of the combined assurance model, they need to address the critical area, amongst others, of risk management as part of their work. If not, it follows that the board, audit committees and other levels of management will remain uninformed on the status of these matters which, in turn, will negatively impact the ability of these stakeholders to discharge their responsibilities. This study therefore focuses on analysing the functioning of IAFs, with specific reference to their risk management mandate. The study followed a mixed method approach to describe internal audits risk management functioning in the big eight metropolitan municipalities in South Africa. The results show that internal audit provide a broad scope of risk management work which assist senior management in the discharge of their responsibilities. However, in the public eye, internal audits risk management functioning is scant.

Keywords: Internal Audit, Risk Management, Public Sector, Municipalities, South Africa, Mixed Methods

1. INTRODUCTION

Successful organisations worldwide are characterised by adherence to sound governance practices. This not only gives them a competitive advantage, but also helps them to provide products and services of quality. Identifying and managing risk as part of an effective risk management process is central to this. In order to achieve this, it is necessary to have a risk management framework or policy and have the right people to actively implement and monitor these processes. The ultimate responsibility for this lies with the board in an oversight capacity and at an operational level with various levels of line management who are responsible for identifying, assessing and mitigating risks. Internal audit is well positioned to assist management in fulfilling its risk management responsibilities by testing, as part of their internal mandate, the effectiveness of controls that are implemented to mitigate risks as well as assessing the overall effective functioning of the risk management process. The work conducted in this regard by internal audit can be very valuable for oversight bodies such as audit committees and senior management in fulfilling their governance mandate.

It is therefore of paramount importance that internal audit functions (IAFs) understand and adhere to best practice industry standards so as to provide effective input into the risk management process in order to deliver value to their organisation. In this regard, this paper explores internal audit's role in the risk management process through a literature review, followed by an empirical review, in order to provide a holistic view of IAFs' role in the risk management functioning of organisations.

2. LITERATURE REVIEW

The IAFs of organisations are regarded as crucial components of the combined assurance model, alongside the audit committee, management and external auditors. The combined assurance model aims at having integrated and aligned assurance in organisations with the overall aim of maximising risk and governance oversight and control efficiencies. In this regard, internal audit plays a crucial role, insofar as it consists of experts in risk, governance and control consultancy who provide assurance to senior management and the audit committee.

Internationally, legislation such as the Foreign Corrupt Practices Act and the Sarbanes-Oxley Act

contributed to increased responsibility placed on boards and audit committees. This is also evident in South Africa with the King Code of Governance (King III). Audit committees are tasked with reporting back to the board of directors on the state of internal control (especially as it relates to internal financial control), risk management and governance processes (Ferreira, 2007:3). Internal auditors are greatly involved in these areas and are thus in a good position to serve as 'informants' to audit committees, which cannot be present on a day-to-day basis. Internal audit can thus assist audit committees in fulfilling their internal control, risk management and governance oversight responsibilities (Guillot, 2013:47).

Audit committees are dependent on internal audit for information and their effectiveness revolves around a strong and well-resourced internal audit function which is able to aid audit committees to meet their oversight responsibilities (Marx & Voogt, 2010:21). Internal audit should therefore reduce the lack of information availability to the audit committee on matters concerning risk management, internal control and governance (Sarens *et al.*, 2009:91; IIA, 2010). This is emphasised by the Institute of Internal Auditors' Research Foundation (IIARF) (2013:17, 18) which states that "internal audit is being asked by the audit committee to do more than ever before in identifying emerging risk, providing assurance on the adequacy of the organization's enterprise risk management processes, assessing the adequacy of governance practices, and more".

Organisations operate in a very complex and competitive environment, facing many risks as well as internal and external forces, continuously hampering organisation objectives (IIA, 2010a:1; Coetzee *et al.*, 2012b:15). Risks facing entities must be managed to an acceptable level so that objectives can be achieved and a decrease in shareholder value can be avoided (Coetzee *et al.*, 2012b:15; IIA, 2012e:1). There is thus a growing demand for managing risk through the process of risk management and internal audit is in a perfect position to assist with the improvement of such processes (Sawyer *et al.*, 2005:1061, 1383; Lyons, 2009:27; Coetzee *et al.*, 2012b:29).

The International Standards for the Professional Practice of Internal Auditing provide mandatory guidance for IAFs on how to contribute to the risk management practices of organisations. In particular, *Standard 2120* provides the minimum requirements for IAFs' work concerning risk management and offers guidance to internal auditors on how to contribute to the improvement of the risk management of organisations by evaluating the effectiveness of these processes (Sarens & Abdolmohammadi, 2011a:6; Lenz, Sarens & D'Silva, 2013:4 and McCollum, 2014:17). In deciding whether risk management processes are effective or not is a matter of judgement once the internal auditor has assessed whether (Arena & Azonne, 2007:100; Almer, Gramling & Kaplan, 2007:65; Warren, 2014:37):

- organisational objectives support and align with the organisation's mission;
- significant risks have been identified and assessed;

- appropriate risk responses have been selected that align risks with the organisation's risk appetite; and

- relevant risk information has been captured and communicated in a timely manner across the organisation.

Risk exposures affecting organisation objectives must be evaluated by internal audit (Ramamoorti & Weidenmier, 2004:320). These objectives includes strategic objectives, reliability and integrity of financial and operational information objectives, effectiveness and efficiency of operations and programme objectives, safeguarding of assets objectives and compliance with laws, regulation, policies, procedures and contracts objectives. This information is obtained by internal audit from various sources and internal audit engagements and assists internal audit in obtaining an overall understanding of the effectiveness of risk management processes (IIA, 2010a:1; IIA, 2012c:11). IAFs must understand the process which gives rise to the risk, determining whether risk responses have been implemented and checking whether these responses are working as intended. This enables internal audit to provide recommendations on whether risks are effectively managed. Lastly, regarding assurance engagements, the internal audit activity must evaluate the possibility of fraud occurring and how fraud risk is managed (Gramling *et al.*, 2013:581; D'Cunha, 2013:64). In this regard, IAFs are not expected to be experts in the field of fraud investigations, but must be able to identify fraud red flags.

Internal auditors can also act in a consulting capacity. During consulting engagements internal auditors must (Sawyer *et al.*, 2005:1364; IIA, 2012c:12) address risks consistent with the organisation's objectives and be aware of other significant risks. They must also use knowledge gained on risks during consulting engagements in their overall assessment of risk management processes and not assume any managing role regarding risk management. Ultimately, management decides on the actual risk management methodology and internal audit must determine whether the chosen methodology is sufficiently comprehensive and appropriate for the nature of the organisation's business (IIA, 2010a:2; IIA, 2013c).

If internal auditors wish to continue being an important aspect of the combined assurance model, they need to address the critical areas of internal control, risk management and governance as part of their work. If not, it follows that the board, audit committees and other levels of management will remain uninformed on the status of these matters which, in turn, will negatively impact the ability of these stakeholders to discharge their responsibilities. This study therefore focuses on analysing the functioning of IAFs, with specific reference to their risk management function.

3. RESEARCH APPROACH

A mixed methods approach was followed, specifically a data transformation triangulation model. This design allows for both quantitative and qualitative data to be collected concurrently which can be combined to give an overall picture of a certain phenomenon (internal audit's risk

management functioning) as part of the final discussion of findings (Edmonds & Kennedy, 2013:149; Grbich, 2013:29). The qualitative data must be transformed to quantitative data in order to be compared with the quantitative data. The data from all the sources is therefore complementary in contributing to the research area. To this end, the most recent public annual reports were obtained from the websites of the eight metropolitan municipalities in South Africa. These documents

were uploaded onto Atlas.ti which was used to perform a coding exercise. Qualitative content analysis and enumerative content analysis (Grbich, 2013:191, 195) was used to provide a deep textual description of the risk management functioning of IAFs, as presented in the public annual reports. The reports were coded using a concept-driven approach. For the concept-driven coding, a coding frame was developed which was imposed on the eight public annual reports (Table 1).

Table 1. Imposed coding frame on public annual reports

<i>Focus areas</i>	<i>Main category</i>	<i>Code assigned in public annual reports to collect evidence on the main category</i>	<i>Code descriptor and examples</i>
Whether internal audit's scope of work includes matters concerning risk management practices	Risk management	Risk management mandate	Any statements or segments of text in the public annual reports which indicated that internal audit was involved in risk management were correspondingly coded. For example, "internal audit evaluate the risk management framework" was coded "Risk management mandate". This provided evidence that internal audit was perceived to be involved in its core area of risk management.

This analysis was focused on internal audit only applying the relevant coding scheme. Detailed questionnaires summarising IAFs' risk management functioning were compiled using the Google Drive and Google Forms function. The questionnaires were completed online via a Uniform Resource Locator (URL) and were sent to audit committees in the eight metropolitan municipalities in South Africa for completion. Once the forms were completed, they were submitted online. The responses were then extracted into Excel, from where they were captured into the IBM Statistical Analysis Software Package (IBM SPSS) for analysis.

Frequency tables and graphs were used to describe the basic meaning of the data combined for all responses. Due to the smaller sample, inferential statistics were not used. The results of the questionnaires were then compared with the transformed qualitative data for triangulation, which is explained in section 4.3 of this paper. After all the data was collected, the two data sets were triangulated to provide a holistic view on internal audit's risk management functioning (section 4.3).

This study was performed with reference to the eight metropolitan municipalities in South Africa – these are the biggest local government organisations which exist in South Africa and data collected from them could serve as a benchmark in informing other, smaller local municipalities as well as internal audit practice in general with reference to the public sector.

In order to ensure confidentiality, pseudonyms were used to describe the metropolitan municipalities, for example, Metro A, Metro B and so forth.

4. FINDINGS

The next section describes the results. The results of the content analysis are presented first, followed by the questionnaire results. Then triangulation points are presented between the two data sets.

4.1. Results of the content analysis

Risk management is one of three core functional areas defined in *Standard 2100*. It follows then, that

if internal audit wishes to add value, it must provide risk management-related consulting and assurance services to the metros. After the analysis of the public annual reports of the metros, the following was evident as it relates to internal audit's risk management mandate in public annual reports.

It can be seen from Table 2 that some metros failed to make any reference whatsoever to the fact that internal audit contributes to the risk management processes of the metro. It is also clear that what internal audit does regarding risk management differs across the metros. According to the Municipal Finance Management Act (MFMA) section 165, internal audit has a legal mandate to advise the accounting officer on matters relating to risk and risk management. Furthermore, the *Standards*, related practice advisories and position papers provide guidance on risk management, Treasury Regulations and the Public Sector Risk Management Framework. Of concern is the extent to which internal audit informs the accounting officer and the audit committee on risk management; the perception is that very little is done on risk management across the metros (perceived in public annual reports).

In order to further understand the qualitative text, Atlas.ti was used to quantify the codes. This is shown in Table 3.

Table 3 shows the number of times reference was made to the core risk management mandate of internal audit in the public annual reports of the metropolitan municipalities. It is clear from Table 3 that inconsistencies exist between what is being reported in terms of the focus area identified. There are also inconsistencies in the frequency of reporting on the focus areas between the municipalities in the public annual reports. For example, Metro C makes no reference to what internal audit is doing regarding risk management. Again, it can be seen in Table 3 that internal audit's perceived functioning, as it relates to its core work, seems insufficient and much more could be communicated in the public annual reports on its core mandates.

Table 2. Internal audit’s work on risk management

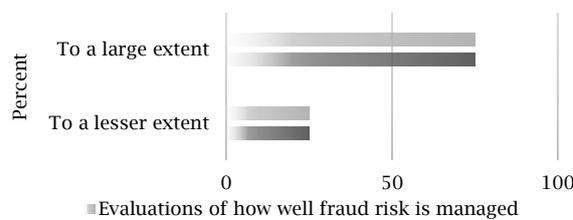
Metro A	Metro B	Metro C	Metro D	Metro E	Metro F	Metro G	Metro H
None	<ul style="list-style-type: none"> Evaluate and improve risk management processes Inform the audit committee, executive directors and the city manager of matters relating to risk management Identify risk exposures effecting the metro strategy 	None	Evaluate whether the risk management design is operating as intended i.e. its adequacy and functioning	<ul style="list-style-type: none"> Evaluate and improve the effectiveness of risk management processes Identify the risk profile of an area under review Evaluate the extent to which management has identified inherent risks Evaluate the adequacy and cost-effectiveness of controls affecting major risks Facilitate good practice on risk management Issue regular risk reports to audit and risk committee 	<ul style="list-style-type: none"> Attend audit committee meetings to inform the committee of key risks Review metro’s compliance with the risk management policy Evaluate the adequacy of the risk management framework of the metro 	Internal audit provides assurance on top risks identified	<ul style="list-style-type: none"> Conduct reviews of the effectiveness of the risk response strategies and any recommended corrective actions Ensure that risks identified through reviews are incorporated into the development of the metro’s risk profile Monitor the implementation of actions to mitigate those risks that are outside the agreed risk appetite of the metro

Source: ATLAS.ti output, “Risk Management Mandate”, Metro A – Metro H

Table 3. Quantified codes on IAFs’ risk management functioning

	Risk management mandate	% Total compared to other Metro’s
Metro A	0	0.00%
Metro B	4	28.57%
Metro C	0	0.00%
Metro D	1	7.14%
Metro E	3	21.43%
Metro F	2	14.29%
Metro G	1	7.14%
Metro H	3	21.43%

Figure 1. Evaluations on fraud



Source: Calculated from IBM SPSS output

4.2. Results of the questionnaires

The following sections discuss audit committee views on internal audit’s risk management functioning and the extent to which these areas assist audit committees in discharging their oversight responsibility.

4.2.1. Internal audit’s assessments of the risk of fraud occurring

The objective of this section is to determine the extent to which audit committees find internal audit’s assessment of fraud risk useful in assisting them in their risk management oversight responsibility and thus show the most prominent risk management functions performed by IAFs.

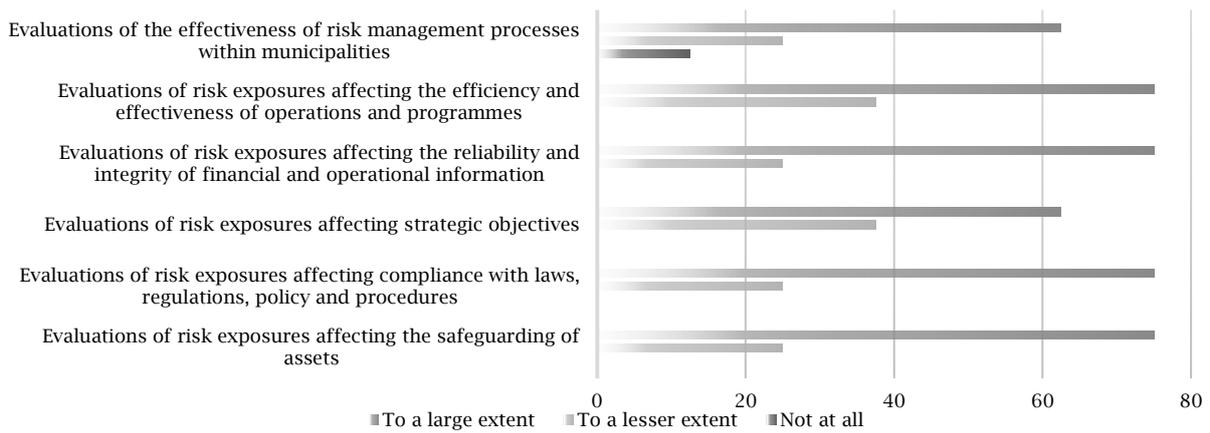
Audit committees are tasked with, amongst other things, risk management oversight responsibility (MFMA, 2003:s166). In this regard, audit committees must act in an advisory capacity to the municipal council, the accounting officer and other management staff. Internal audit is in a perfect position to provide feedback to audit committees on the state of risk management within municipalities as it is largely tasked with providing an independent, objective evaluation of the efficiency and effectiveness of risk management processes. The following figures demonstrate the extent to which internal audit is assisting audit committees with their risk management oversight responsibly.

The *Standards* require internal audit, as part of its risk management mandate, to evaluate the potential for fraud occurring and assess how well the municipality manages fraud. Internal audit does not need to have expert knowledge in fraud investigations, but it must be able to identify fraud ‘red flags’ and communicate these to relevant individuals within the municipality. Although audit committees are not directly tasked with oversight responsibility for fraud, they must advise on the financial affairs of the municipality and thus, the possibility of financial statement fraud. In this regard, 75% of audit committees in metros indicated that internal audit’s evaluations of the possibility of fraud occurring assisted them in their risk management oversight responsibility. Evaluations by internal audit on how well the municipality manages its fraud risk also assisted audit committees (75%) in their risk management oversight responsibility. Internal audit evaluations can thus provide information to audit committees on fraud management programmes designed to counter financial statement fraud.

4.2.2. Internal audit’s specific risk management evaluations

This section determines the extent to which audit committees find internal audit’s specific risk management evaluations useful in assisting them in their risk management oversight responsibility, thus also showing the most prominent risk management functions performed by IAFs in this regard.

Figure 2. Specific risk management evaluations



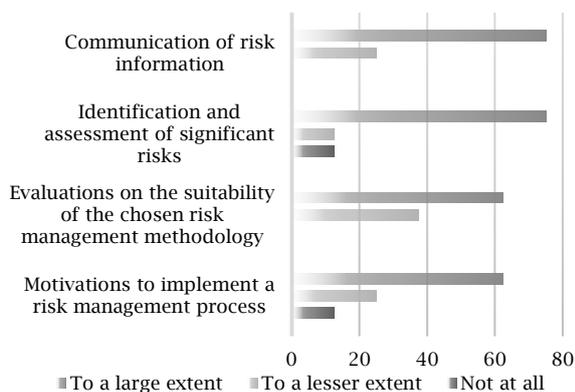
Source: Calculated from IBM SPSS output

Internal audit must contribute to the risk management processes of a municipality by independently and objectively evaluating the efficiency and effectiveness of risk management processes. Internal audit can assist audit committees in their mandate, as found in the MFMA regarding the provision of advice on risk management (MFMA, 2003:s166). The results clearly show that audit committees in metros found internal audit's work on risk management useful in assisting them with their risk management oversight. Seventy five percent of audit committees indicated that evaluation of risk exposure affecting the safeguarding of assets, the reliability of financial and operational information and compliance with laws and regulations assisted audit committees. Audit committees must also provide advice on compliance issues regarding the MFMA, the Division of Revenue Act and any other relevant legislation (MFMA, 2003:s166) - they therefore find internal audit compliance work useful in assisting them.

4.2.3. Internal audit's promotion of risk management efforts

This section determines the extent to which audit committees find internal audit's promotion of risk management efforts useful in assisting them in their risk management oversight responsibility, thus showing the most prominent risk management functions IAFs perform in this regard.

Figure 3. Promotion of risk management efforts



Source: Calculated from IBM SPSS output

The audit committees of two metros indicated that internal audit did not assist them with the identification and assessment of significant risks nor did internal audit's motivations to implement a risk management process assist them. The majority (75%) of respondents nonetheless indicated that internal audit's identification and assessment of risks assisted the audit committee in their risk management oversight responsibility. This is due to the fact that audit committees are dependent on internal audit to provide them with risk management information so that they can, in turn, fulfil their mandate, as stipulated in the MFMA on risk management advice (MFMA, 2003:s166). This can only happen if internal audit communicates risk information and audit committees (75%) feel that these communications assist them to a large extent in their responsibilities. Audit committees do not appear to be overly concerned about the suitability of the chosen risk management methodology as only 62.5% of audit committees indicated that this assisted them. This could be due to the fact that they are more concerned with the effectiveness of risk management and its impact on the municipalities' objectives.

4.2.4. Internal audit's evaluations on the alignment of risk

This section determines the extent to which audit committees find internal audit's evaluations of risk alignment with the metros mission statement useful in assisting them in their risk management oversight responsibility, thus showing the most prominent risk management functions performed by IAFs in this regard.

Fewer audit committees (62.50%) in metros felt that evaluations by internal audit on alignment between risk and metros' mission statement assisted them. Only 50% of audit committees felt that evaluations of the alignment of risk responses with the risk appetite of the metro assisted them in their risk oversight responsibility.

4.2.5. Internal audit's knowledge of risk practices

This section determines the extent to which audit committees find internal audit's knowledge of risk practices useful in assisting them in their risk

management oversight responsibility, thus showing the most prominent risk management functions IAFs perform in this regard.

Figure 4. Evaluations on the alignment of risk with municipality mission

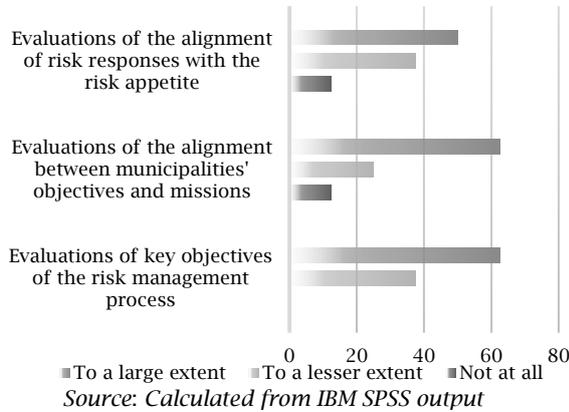


Table 4. Audit committee views on internal audit's knowledge of risk practices

Knowledge of risk practices	Not at all		To a lesser extent		To a large extent		Total responses
		%		%		%	
Internal audit's broad knowledge on risk practices at the municipality (E14.13)	-	-	3	37.50%	5	62.50%	8

Source: Calculated from IBM SPSS

Only 62.50% of audit committees in metros felt that internal audit's knowledge of risk practices in municipalities assisted them in their risk oversight responsibility. Best practice states that internal audit should be a source of information to the audit committee and seeing that audit committees are tasked by the MFMA with providing advice on risk management, more must be done for internal audit to be useful in this regard.

4.3. Triangulating public annual report data with questionnaire data

This section triangulates public annual report data with audit committee responses in order to validate, compare and interrelate the work of internal audit in the area of risk management. This provides a holistic description of IAFs' risk management functioning from the perspectives of audit committees and public annual report data.

In order to triangulate the public annual report data with audit committee responses, the relevant frequency counts from Table 3 were used. For the work area, risk management, the total amount of work as per the public annual reports was calculated by means of *quantitising* the qualitative texts (this shows the total perceived work per annual reports). During the literature review, the study defined 16 risk management areas IAFs must perform (these

formed the questions in the questionnaires). This amount was multiplied by eight (all the metros) to arrive at the totals (defined work per literature review). This was expressed as a percentage by dividing the total perceived work per annual reports, with the defined work in the literature. The frequency counts were thus further transformed into quantitative data. This calculation is shown in Table 5 below.

Table 5. Perceived work in public annual reports

	Risk management mandate
Metro A	0
Metro B	4
Metro C	0
Metro D	1
Metro E	3
Metro F	2
Metro G	1
Metro H	3

Work areas	Risk management
Total perceived work per annual reports	14
Defined work per literature review	128
Expressed as a percentage	11%

Source: Researcher's own calculation

As indicated in Table 5, the perception given is that internal audit only performs 11% of possible risk management work. This is a negative perception for the reader of public annual reports and is not a true reflection of the work performed by internal audit. The audit committee responses on the area of risk management were totalled for areas where audit committees indicated both 'to a large extent' and 'to a lesser extent' in the audit committee questionnaire. The fact that audit committees selected 'to a lesser extent' does not mean internal audit did not perform the work, hence its inclusion in the total. Table 6 below shows the results.

Table 6. Totalled audit committee responses for internal audit's risk management work

Work areas	Risk management
Total actual work as per audit committee questionnaires (all metros)	123
Defined work per literature review	128
Expressed as a percentage	96%
Annual report data from Table 5	11%

Source: Researcher's own calculation

From Table 6 it is clear that the scope of work conducted by internal audit is much greater than what is depicted in the public annual reports. This discrepancy could be due to the fact that no legal obligation exists for internal audit to report in public annual reports. Audit committees in metros indicated that internal audit conducts 96% of risk management work versus 11% in public annual reports.

5. CONCLUSIONS

In light of IAFs being important role players in risk management practices within organisations, this study aimed at describing IAFs' risk management

functioning holistically from two perspectives, that is, audit committees and public annual report data in metropolitan municipalities in South Africa.

Section 4.1 provided empirical evidence on the disclosure of the work internal audit conducts, as reflected in public annual reports. The extent of work depicted versus what is prescribed by the *Standards* and other best practices varies extensively across metros, as can be seen in the text matrices (Table 2 and 3). Thus in the public eye, internal audit's risk managements functioning is limited. However, when the public annual report data was compared with audit committee responses, it showed that internal audit is doing much more than is depicted in public annual reports (section 4.3). This means that IAFs' functioning, as portrayed in public annual reports, is not a true reflection when compared to the actual work as perceived by audit committees. Opportunity thus exists to create internal audit disclosure policies which could increase public confidence as well as the overall functioning of IAFs, which would be under public scrutiny.

Furthermore, the study indicated which risk management practices of IAFs are important for audit committees (section 4.2) in fulfilling their oversight responsibilities and can be used as a benchmark for other IAFs to realign their risk management practices to serve the oversight bodies.

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