

THE STATE OF INTERNAL AUDIT'S REGULATORY MANDATE

Christo Ackermann*

*University of Johannesburg, South Africa

Abstract

The importance of an effective internal audit function in South African municipalities have been recognised insofar as internal audit functions are legally mandated to exist within municipalities. This also means that legally, internal audit has certain mandates which must be fulfilled in order to add value to management and audit committees, and ultimately, to the board of directors. Even though internal audit is sanctioned by this important legal mandate, evidence shows that internal audit does not always fulfil this mandate. This state of affairs has prompted a detailed review of the relevant laws and regulations governing the work of internal audit in South African municipalities in order to determine the extent to which key stakeholders find the regulatory work of internal audit useful in discharging their (stakeholders') oversight responsibilities. Questionnaires were administered to audit committees. The results summarise the extent to which internal audit's work assists audit committees in their oversight responsibilities as this ultimately affects the ability of audit committees to fulfil these responsibilities to the board of directors. The results indicate that audit committees are greatly dependent on internal audit as a provider of assurance on a variety of legally mandated variables. The results of this study can be used as a measure of best practice of the legally mandated duties performed by internal audit. It can also be used by other researchers in comparative studies and by practitioners to benchmark their work in order to better serve audit committees and ultimately, the board of directors.

Keywords: Internal Audit Functioning, Regulatory Mandate, Municipalities, South Africa, Audit Committees

1. INTRODUCTION

Prior to the Constitution of 1996 (the Constitution), local government, then known as local authorities, was largely directed by provincial government (Tsatsire, Raga, Taylor & Nealer, 2009:132; South African Local Government Association (SALGA), 2011). Although the laws and regulations imposed by provincial governments led to procedures and structures, the local authorities had no constitutional rights (SALGA, 2011). Their powers and rights were imposed by provincial governments and they existed at the mercy of their legislature which rendered all local authorities' actions subject to review (SALGA, 2011). These local authorities were racially segregated and the rendering of services was unequal for a large portion of the population (SALGA, 2011).

With the passing of the Constitution in 1996, a new era was born in South Africa where local municipalities were created for all areas, each having the authority to govern the municipal area it served (SALGA, 2011). In 1998, the White Paper on Local Government by cabinet provided a framework for correcting the way local government had been governed by working with people to improve their lives (SALGA, 2011).

It is argued that the Constitution and the White Paper on Local Government set the foundation for important legislation which enabled local government to fulfil its constitutional mandate of

developmental local government (Tsatsire *et al.*, 2009:144; van der Waldt, Khalo, Nealer, Phutiagae, van der Walt, van Niekerk & Venter, 2014:52/53). Table 1 below provides, in chronological order, a summary of these pieces of important legislation.

Table 1. Legislative framework for the local government sphere in South Africa

| Legislation | Overview in context of this study |
|--|--|
| The Constitution of the Republic of South Africa of 1996 | Authorised the creation of the distinct local government sphere and provided for the status of local municipalities and categories of municipalities. |
| Municipal Demarcation Act 27 of 1998 | Was formed to establish the municipal and ward boundaries for categories of municipalities set out in the Constitution. |
| Municipal Structures Act 117 of 1998 | Provided for the different categories and types of municipalities, thus establishing criteria for the establishment of either category or type of municipality. |
| Municipal Systems Act 32 of 2000 (MSA) | Set out the core principles, mechanisms and processes to efficiently and effectively enable local government to achieve its constitutional mandate. |
| Municipal Finance Management Act 56 of 2003 (MFMA) | Provided best practices for the overall financial management of a local municipality, thus contributing to a better managed and accountable local government sphere. |

Source: van der Waldt *et al.*, 2014:54-68

The Constitution thus provided the legislative framework for the existence of a new, distinct sphere of government. Within the local government sphere, municipalities are an entity or organ of state, responsible for service delivery (van der Waldd *et al.*, 2014:53). After the Constitution, the key legislation described in Table 1 was promulgated. These laws, specifically the MFMA, mandated the existence of an internal audit function within municipalities and provided for a legislative framework for internal audit.

Internal audit plays a crucial role in assisting audit committees to meet their objectives, namely, internal control oversight, risk management oversight, governance oversight and financial reporting oversight. It is clear that pressure exerted on IAFs via audit committees amongst others, emphasises the importance of having a properly functioning IAF. If internal auditors wish to continue to play a meaningful role in 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.

In the municipal context in South Africa, internal audit is legally mandated to exist, playing an important role as consultants and assurance providers on internal control, risk management and governance. For audit committees to be effective in their oversight responsibilities, they need relevant information from internal audit. If such information is unavailable, key decisions will be based on inaccurate, incomplete and unreliable information (Gramling, Maletta, Schneider & Church, 2004:198; Ramamoorti & Evans, 2011:27; Auditor-General South Africa, 2012:87; Hooper, 2013:15).

2. PROBLEM FORMULATION

It has been argued that audit committees and internal audit are partly to blame in corporate scandals such as Enron and WorldCom (Ferreira, 2007:4). This clearly suggests that the IAFs may not have been functioning as effectively as they could have. Lenz and Sarens (2012:534) further reference major collapses such as Parmalat, Ahold and Lehman Brothers as all being due to corporate governance and risk management failure, areas which are critical for the scope of internal auditors. The Supreme Audit Institution in South Africa stated that audit committees and internal audit were "in part to blame for auditees not obtaining clean audit reports" (Auditor-General South Africa, 2012:86). Some of the major reasons cited for this failure were IAFs not doing what was expected of them, as prescribed in the legislative framework. In this regard the Auditor-General South Africa specifically stated that IAFs do not adequately evaluate internal control and therefore did not fully communicate with the audit committee on matters such as accounting, risk management and loss control (Auditor-General South Africa, 2011:32; Auditor-General South Africa, 2012:86; Auditor-General South Africa, 2013:31, 35, 75, 103). This underpins the motivation for the present study which aims to determine the extent to which IAFs are doing what is required of them, as mandated in key legislation.

3. INTERNAL AUDIT IN SOUTH AFRICAN MUNICIPALITIES

The following sections provide an overview of the acts and regulations which mandate the work of internal audit with specific focus on relevant sections.

3.1. The Municipal Finance Management Act

The MFMA was promulgated in 2003 with the aim of achieving the following objectives within local government in South Africa (MFMA, 2003:s2):

- To secure sound and sustainable management of the financial affairs of municipalities and other institutions in the local sphere of government;
- To establish treasury norms and standards for the local sphere of government; and
- To provide for any related matters.

From the above, it is clear that the MFMA creates a compulsory framework to help all municipalities, all municipal entities and national and provincial organs of state (to the extent of their dealings with municipalities) to achieve objectives related to financial reporting, operational efficiency and effectiveness, compliance with laws and regulations and the safeguarding of assets - all of which form part of internal audit's mandate.

The MFMA states that a municipality must have an IAF. Specifically, it is the responsibility of the accounting officer to ensure that an IAF is established (MFMA, 2003:s62(1)(c)(ii), s95(c)(ii)). The MFMA (2003:s165) states that the IAF is responsible for the following:

- Preparing a risk-based audit plan and an internal audit programme for each financial year;
- Advising the accounting officer and reporting to the audit committee on the implementation of the internal audit plan and matters relating to:
 - Internal audit;
 - Internal controls;
 - Accounting procedures and practices;
 - Risk and risk management;
 - Performance management;
 - Loss control;
 - Compliance with this Act, the annual Division of Revenue Act and any other applicable legislation;
- Perform such other duties as may be assigned to it by the accounting officer.

3.2. The Municipal System Act

Not much is stated in the MSA regarding the functioning of IAFs. However, section 49(1)(g) does allow the minister to create guidelines or regulations for the IAF regarding the audit of performance measures (MSA, 2000:s49(1)(g)). This topic is dealt with in more detail under the Municipal Planning And Performance Management Regulations (MPPMR) and the Municipal Performance Regulations For Municipal Managers And Managers Directly Accountable To Municipal Managers (MPRMM). However, internal audit is responsible for auditing compliance with Chapter 6 of the MSA, as prescribed by the MPPMR.

Chapter 6 of the MSA states that a municipality must establish a performance management system (PMS) (MSA, 2000:s38) that is:

- commensurate with its resources;
- best suited to its circumstances; and
- in line with the priorities, objectives, indicators and targets contained in its Integrated Development Plan (IDP).

IAFs in municipalities in South Africa must conduct compliance testing on Chapter 6 of the Municipal Systems Act to contribute to the PMS of each municipality.

3.3. Municipal planning and performance management regulations

Each municipality must have a PMS and must show how the municipality plan monitors, measures, reviews, reports and improves on performance measures (MPPMR, 2001:Regulation 7(1)). Internal auditing plays a crucial role in independently auditing these performance measures. The MPPMR outlines the responsibilities of internal audit departments regarding the auditing of performance measures which are listed below.

- The municipality must ensure that systems are in place to allow for the auditing of performance measures by internal audit.
- The auditing of performance measures must include an assessment of:
 - The functionality of the municipality's Performance Management System (PMS);
 - The compliance of the PMS with the Act (Chapter 6 of the MSA); and
 - The extent to which the municipality's performance measurements are reliable in measuring the performance of municipalities on indicators referred to in Regulations 9 and 10.
- The IAF must, on a continuous basis, audit the performance measurements of the municipality and submit quarterly reports of their audits to the municipal managers and the performance audit committee (Regulation 14(1)(a), (b) and (c)).

In the context of the above regulations, it is important for internal audit to establish the functionality of a municipality's PMS and to determine whether the selected performance measures are relevant to the municipality. Each municipality must report on set performance indicators and internal audit, as part of the above regulations, must determine whether the reported performance indicators are reliable. The work that internal audit conducts on regulation (14) (a) (b) (c) must be reported quarterly to the municipal managers and the performance audit committee. In essence, this regulation leads to internal audit conducting performance auditing, namely, assessing whether municipalities achieve their strategic objectives, as set out in the IDP and the Service Delivery Budget Implementation Plan, in the most economical and efficient manner and whether the controls to achieve this are effective (Annexure F provides some definitions of performance auditing).

3.4. Municipal performance regulations for municipal managers and managers directly accountable to municipal managers

Chapter 3 of the MPPMR states that the IAF must audit the performance measurements set by a municipality (refer to Section 4.4.3). In this regard, the MPRMM states that municipal managers and other managers must adhere to the PMS adopted by the

municipality (Government Gazette, 2006:Regulation 26(1)). It is therefore important for internal audit, as part of its auditing mandate, to audit the performance agreements and contracts of these individuals. The MPRMM aims to achieve the following (Government Gazette, 2006:1):

These regulations seek to set out how the performance of municipal managers will be uniformly directed, monitored and improved. The regulations address both the Employment Contract of a municipal manager and managers directly accountable to municipal managers, as well as the Performance Agreement that is entered into between respective municipalities, municipal managers and managers directly accountable to municipal managers. These instruments will, in combination, ensure a basis for performance and continuous improvement in local government.

As part of its audit mandate, internal audit must therefore conduct compliance audits on this regulation with reference to the performance agreements and employment contracts of municipal managers and managers accountable to them (municipal managers).

3.5. The Treasury Regulations

The Treasury Regulations are issued in terms of the Public Finance Management Act no. 1 of 1999 (PFMA) and the Constitution of South Africa (Janse van Rensburg & Coetzee, 2011:49). They are applicable to all departments, public entities, constitutional institutions and the South African Revenue Services (National Treasury, 2005:3; Janse van Rensburg *et al.*, 2011:49). The Treasury Regulations provide criteria for IAFs to guide them in their functioning. These sections are highlighted in the following sections.

The Treasury Regulations provide IAFs with guidance on effective functioning. These compulsory criteria can be found in Section 3.2 of the Treasury Regulations. Many of the criteria in the Treasury Regulations regarding internal audit are consistent with the *Standards*, focusing more on the attributes of the internal audit function, with some elements of performance activities. For example, internal audit must plan all audit engagements which must be based on the major risks facing the entity. The *Standards* require internal audit's work to be documented in a charter and require internal audit to be independent, all of which forms part of the Treasury Regulations. The work of internal audit, as prescribed in the Treasury Regulations, is also consistent with the *Standards* with reference to its control evaluation mandate.

4. RESEARCH METHODOLOGY

4.1. Instrument design and data collection

The functioning of internal audit, as defined by literature, law, internal audit *Standards*, best practice such as the internal audit practice advisories and other rules and regulations, was used to create a questionnaire. The questionnaire was distributed to audit committee chairpersons at the eight selected metropolitan municipalities in South Africa. Chief Audit Executives (CAE) were contacted and asked to please distribute the questionnaires to their audit committees, as a functional reporting relationship exist between audit committees and

CAEs. They were asked to document their views on internal audit functioning. The questionnaires were compiled using Google Drive and the Google Forms function. The questionnaires were completed online via a Uniform Resource Locator (URL) and were sent to the audit committee chairpersons. Once the forms were completed, they were submitted online. The responses were then extracted into Excel, from whence they were captured into the IBM Statistical Analysis Software Package (IBM SPSS) for analysis. The online questionnaires were useful as a method, considering that the selected municipalities are regionally dispersed and the participants have very busy schedules. This allowed for easy, quick and low cost means of data collection (Evidence Base, 2006)..

4.2. 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.

4.3. Sample selection

The eight metropolitan municipalities in South Africa was purposively selected. These are large municipalities serving the biggest economic hub's in South Africa. They are thus regarded as *information-rich* (Patton, 1990:176/177) and results from these

metro's can be informative to other smaller municipalities.

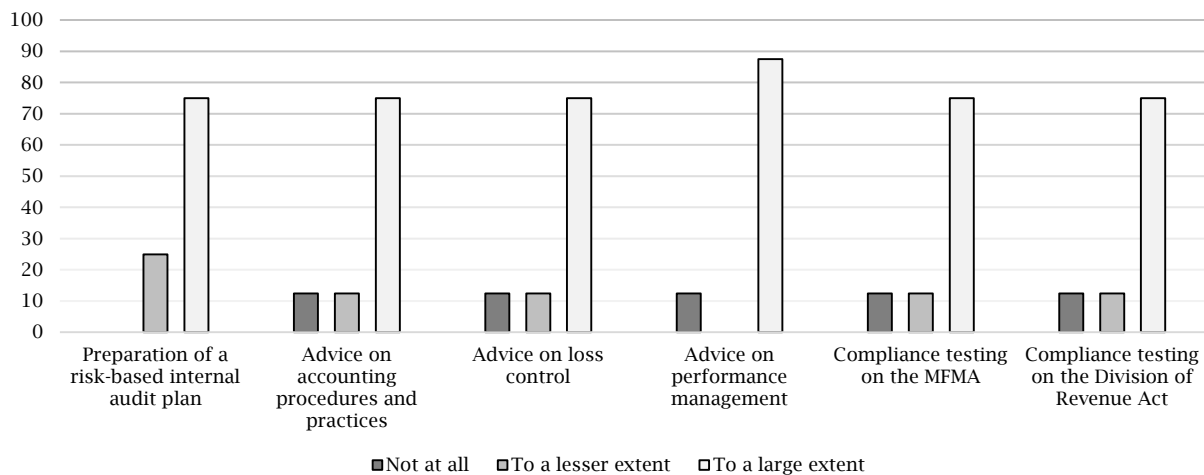
5. RESULTS

The following sections discuss audit committee views on internal audit's regulatory mandate and the extent to which these areas assisted audit committees in discharging their oversight responsibilities.

5.1. Audit committee views on internal audit's broad mandate in the MFMA

Audit committees are tasked with, amongst other things, acting in an advisory capacity to municipal council, the accounting officer and other management staff. In this regard, audit committees must provide feedback on the performance management system of a municipality, compliance with the MFMA and the Division of Revenue Act and any other ad hoc compliance issues (MFMA, 2003:s166). Internal audit is tasked with auditing the performance management system of a municipality as well as conducting numerous compliance audits. They are thus in a position to communicate the outcome of these audits to the audit committee so that they in turn can comply with Section 166 of the MFMA. Figure 1 below illustrates the extent to which internal audit assists audit committees with reference to Section 166 of the MFMA requirements.

Figure 1. Internal audit's broad mandate in the MFMA



Source: IBM SPSS output

According to the MFMA, each municipality must have an internal audit function and must prepare a risk-based audit plan, advise the accounting officer and report to the audit committee on the implementation of the plan (MFMA, 2003:s165). Internal audit must advise on the following matters, as indicated in the MFMA Section 165:

- Internal audit;
- Internal controls;
- Accounting procedures and practices;
- Risk and risk management;
- Performance management;
- Loss control;
- Compliance with the Act, the annual Division of Revenue Act; and

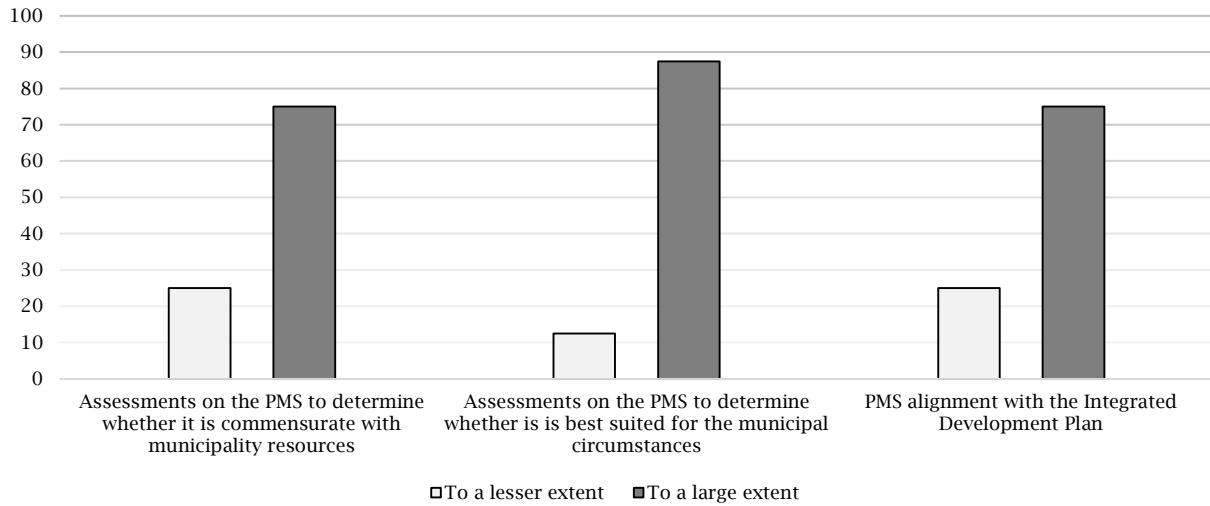
- Any other applicable legislation.

Audit committees are tasked with giving advice on internal control (especially internal financial control), effective risk management, performance management and compliance with the MFMA and the Division of Revenue Act (MFMA, 2003:s166). Considering the link between the work of internal audit and audit committee requirements, internal audit is an important role player in assisting audit committees regarding the above matters. Figure 1 above indicates that internal audit greatly assists audit committees in meeting their regulatory demands, as outlined in Section 166 of the MFMA.

5.2. Audit committee views on internal audit's mandate in Chapter 6 of the MSA

Figure 2 below summarises the results.

Figure 2. Chapter 6 of the Municipal Systems Act



Source: IBM SPSS output

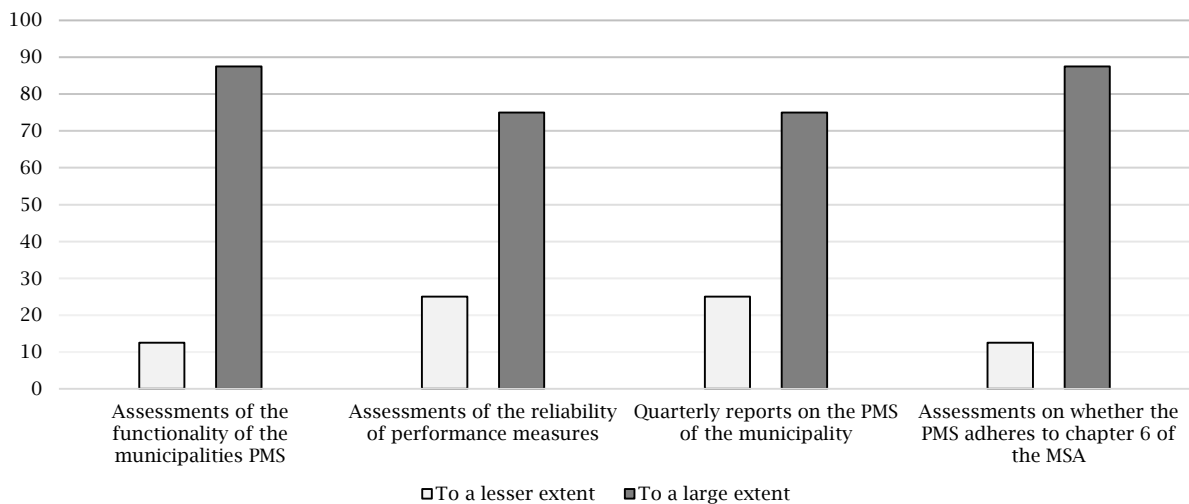
The Municipal Planning and Performance Management Regulations state that internal audit must conduct a compliance audit on Chapter 6 of the Municipal Systems Act which deals with performance management within municipalities. From Figure 2 it is clear that internal audit's assessment of compliance with Chapter 6 of the MSA greatly assisted audit committees (87.50%) in municipalities in their legal and regulatory oversight, especially in giving advice on performance

management, as stated in the MFMA Section 166. This assists the audit committees in making informed decisions on the status of performance management within the municipality.

5.3. Audit committee views on internal audit's mandate in the MPPMR

Figure 3 below summarises the results.

Figure 3. Requirements of the municipal planning and performance management regulations



Source: IBM SPSS output

Figures 3 above show strong evidence that audit committees in municipalities rely on internal audit to assist them in their compliance mandate as in most cases, audit committees indicated the work areas of internal audit assisted them to a large extent. This stems from the fact that audit committees must legally provide advice to the

accounting officer, municipal council, political office-bearers and management staff of a municipality, as stated in Section 166 of the MFMA. The fact that internal audit is tasked with evaluating the PMS of municipalities is evident in the results as it is in a perfect position to assist audit committees in this regard.

5.4. Audit committee views on internal audit's mandate in the MPRMM

Table 1 below summarises the results.

Table 1. Audit committee views on the alignment of performance agreements with the performance management regulations for municipal managers and those accountable to municipal managers

| <i>Internal audits mandate in the MPRMM</i> | <i>Not at all</i> | <i>%</i> | <i>To a lesser extent</i> | <i>%</i> | <i>To a large extent</i> | <i>%</i> | <i>Total responses</i> |
|---|-------------------|----------|---------------------------|----------|--------------------------|----------|------------------------|
| Internal audit's assessment on whether the actual performance agreements and contracts are in line with the requirements of the MPRMM | 4 | 50.00% | 2 | 25.00% | 2 | 25.00% | 8 |

Source: IBM SPSS output

Only 25% of audit committees felt that internal audit's assessment of the alignment of actual performance agreements and contracts with the Performance Management Regulations for Municipal Managers and those accountable to Municipal Managers, was assisting audit committees in their oversight responsibilities. The Performance Management Regulations for Municipal Managers and those accountable to Municipal Managers set the minimum requirements for the performance agreements of municipal managers and those reporting directly to the municipal manager. It is

thus part of the mandate of internal audit to check compliance of the performance agreements and controls with the requirements of these regulations. However, audit committees in municipalities did not find this useful in assisting them and 50% indicated that this did not assist them at all.

5.5. Audit committee views on internal audit's quarterly reports on the internal audit plan

Table 2 below summarises the results.

Table 2. Audit committee views on quarterly status reports from internal audit

| <i>Internal audit quarterly reports</i> | <i>Not at all</i> | <i>%</i> | <i>To a lesser extent</i> | <i>%</i> | <i>To a large extent</i> | <i>%</i> | <i>Total responses</i> |
|--|-------------------|----------|---------------------------|----------|--------------------------|----------|------------------------|
| Quarterly reports from internal audit on the status of the completed internal audit plan | 1 | 12.50% | - | - | 7 | 87.50% | 8 |

Source: IBM SPSS output

Not surprisingly, 87.50% of audit committees in municipalities indicated that internal audit's quarterly report on the status of the completed internal audit plan assisted them in their oversight responsibility. The Treasury Regulations require internal audit to provide this quarterly feedback to the audit committee. This gives audit committees a chance to identify areas where they still need input from internal audit to assist them in their oversight responsibilities. The results also show that reports were issued by internal audit and emphasise the importance of these reports as this is the point where audit committees are informed on the status of internal control, risk management, governance and compliance matters.

6. CONCLUSIONS

Section 5 provided an overview of the legislative work internal audit performs in metropolitan municipalities and the extent to which audit committees find this useful in assisting them in their legal and regulatory oversight responsibilities. This section found that internal audit plays a crucial role in assisting audit committees in their legal and regulatory oversight responsibility in varying degrees. This means audit committees and management are informed on important compliance issues which can, in turn, assist them in their oversight responsibilities. The legislative mandate of internal audit is, amongst others, structured in such a way that IAFs must perform work on internal control, risk management and governance processes, which give key stakeholders such as senior

management and audit committee's independent assurance on the status of these areas. This in turn would assist key stakeholders in their operational and financial oversight responsibility and could contribute significantly to municipalities obtaining 'clean' audits.

The results of the study shows that internal audit is doing a good job in keeping stakeholders informed on key compliance related issues and that stakeholders find this work useful in assisting them (stakeholders) in their oversight responsibility. It is therefore important for IAFs to continue to comply with their legislative mandates as their work is used by stakeholders for decision making. Practitioners must also take note of the areas where audit committees indicated that they do not find work useful - this will assist IAFs to adapt to the needs of their stakeholders and to reflect on the extent they adhere to their legal mandate. Furthermore, the results of this study can also be used in comparative studies on the legal mandate of internal audit or they can be used as a point of reference for practitioners on the requirement by internal audit regarding its regulatory mandate in South African municipalities.

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