

# ESTABLISHING THE RELATIONSHIP BETWEEN AN EFFECTIVE AUDIT COMMITTEE AND INFUSION OF A GOOD CONTROL ENVIRONMENT

Zandile Virtue Dlamini <sup>\*</sup>, Emmanuel Mutambara <sup>\*\*</sup>,  
Akvesi Assensoh-Kodua <sup>\*\*\*</sup>

<sup>\*</sup> Graduate School of Business & Leadership, University of KwaZulu-Natal, South Africa

<sup>\*\*</sup> Corresponding author, Graduate School of Business & Leadership, University of KwaZulu-Natal, South Africa;  
Contact details: Private Bag X54001, Durban, 4000, South Africa

<sup>\*\*\*</sup> Department of Entrepreneurial and Management Sciences, Durban University of Technology, South Africa



## Abstract

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Audit Committees are a vital component of accountability and good governance for any serious organisation and have progressively been perceived as an integral part of modern control structures and control practices in both the public and private sectors. However, Audit Committees can only discharge such gigantic responsibilities in a conducive environment to provide its effective performance of certain key functions in the areas of oversight of risk management, reporting, and internal controls. Nonetheless, the enablement of such conducive environments has become a challenge to many Audit Committees. It is against this background that this study investigates the relationship between an effective audit committee and infusion of a good control environment. The study used structured and unstructured questions to investigate population comprising standing committee members and Audit Committee members. Thus this study made use of a mixed methodology to collect quantitative data as well as reviewing audit documents, such as, the Audit Committee Charter and minutes of meetings in order to ascertain the environment under which such august practices are performed. The outcome concludes that the Audit Committee which was selected for the study has the good working environment.

**Keywords:** Audit Committee, Control Environment, Governance, Local Governments

## 1. INTRODUCTION

Local government is at the focal point of service delivery in any country in the world as it is near to people on the ground (Hussein, 2017). For it to be seen as transparent and corruption free, it is a prerequisite that it operates in an environment perceived free from any form of capture and suspicion (Kewo, 2017). However, due to the shortage of people with financial skills and technical expertise, many of the audit committee members in eThekweni municipality have taken other roles to serve in other capacities. This brings up an issue concerning how effective audit committee is, compelling the view that the majority of audit

committees are merely a rubber stamp (Junali and Siti-Nabiha, 2015). Based on this view management sees no worth in audit committees but rather label it a complete waste of time and resources (Kewo, 2017). This study, therefore, investigates the relationship between an effective audit committee and infusion of a good control environment with a view to enhance the role and functions of audit committees ultimately improving the overall performance of municipalities.

The paper presents the motivation for study followed by literature review in the study area, the method for analyses leading to the results and discussion of the study. A brief outline of the limitations of the study is presented, followed by recommendations and conclusion.

### 1.1. Motivation for the study

The South African government type is established based on majority rule government with a constitution that is regarded as the most progressive in the bill of rights and second to none. All spheres of government are relied upon to have unqualified audit opinions, which means no findings concerning noncompliance with laws and regulations (AGSA, 2011:13) are tolerated.

Nevertheless, corruption and poor service delivery have become potential menace confronting many municipalities, to the extent that, corruption alone is labelled one of the impediments of good governance, effective and efficient service delivery (Lawal and Oladunjoye, 2010). Many recent protests for service delivery and non-participation of certain communities in local government elections is a clear indictment of the peoples' dissatisfaction with the local governance in South Africa (Jonas, 2011:4). The Municipal Finance Management Act (MFMA) (56 of 2003) places key obligations on the Audit Committee to correct such ill-fated situations, but such important functioning is only possible in an environment of transparency, and synergies between assurance providers, such as internal and external auditors. The independence of these assurance providers is crucial as the public relies on them for trust. Flowing from the above, this study is meant to determine whether the Audit Committees in the public sector are effective, given the significance of the role that they play in the governance structure with respect to financial reporting, internal control, risk management, and other related aspects, in addition to the recent improvements in the legal, regulatory and business environment required in South Africa. This is to establish the relationship between an effective Audit Committee and infusion of a good control environment.

## 2. LITERATURE REVIEW

### 2.1. Definition of Audit Committee

The MFMA Act 56 of (2003:156) defines the Audit Committee at Local Government level as an independent advisory body to the council of the Municipality with clearly defined functions, roles, responsibilities and powers. The key aspect of the above definition is that it is a committee of the Municipal Council or any organization that should assist in fulfilling oversight responsibility, particularly with regard to issues of financial management, risk management, internal audit and compliance. Hence, Audit Committees are crucial key component of corporate governance

They are a key source of assurance for organisations arrangements for managing risk, maintaining an effective control environment, and reporting on financial and non-financial performance (CIPFA, 2005:16). For this responsibility to be realised, it is important that the Audit Committee becomes an independent entity in corporate governance. This will enable it to ensure the integrity of integrated reporting and financial controls, the proper identification and management of financial risks and the integrity of the reporting practices (King III, 2009:59).

### 2.2. The relationship between an effective audit committee and infusion of good control environment

In the most recent period academics are increasingly giving attention to audit committee roles as a component of corporate governance with a focus on effectiveness and control (Chen, Duh & Shiue, 2008; Davies, 2009; Barua, Rama & Sharma, 2010; Alkdai & Hanefah, 2012), due to the fact that audit committees are perceived as the only tool for ensuring effective control mechanisms. Thus, audit committees are taunted the most effective means towards reducing corporate inefficiency that has bedevilled the public sector (Owolabi & Dada, 2011). Despite concerns by other academics, that audit committee was unsuccessful towards protecting corporate failures; there is huge evidence on the ground that highlight on the critical role played by audit committees (Ogbada, Orok & Esang, 2009). Over the years, serious consideration has been given towards the encouragement of audit committee effectiveness to promote corporate effectiveness ultimately enhancing the effectiveness of the committees (Owolabi & Dada, 2011). In achieving the mandate to ensure control, audit committees, require a feasible and conducive environment. Thus, the Auditing Standard ASA 315, (2006:30) as quoted in the KPMG (2012) states that "the control environment of the Audit Committees should include the governance and management functions, and the attitudes, awareness, and actions of those charged with governance and management of the entity's internal controls and its importance. The control environment sets the tone of an organization, influencing the control consciousness of its people." The control environment is the foundation of an effective internal control structure.

Audit committees become effective when they meet the goals for which they were established which include the improvement of the entity's overall governance (David, 2009; Haron, Chambers, Ramsi & Ismail, 2005). It is important to note that, arising from the relevance of audit committees in general, there has been an increase on the establishment of audit committees across the globe to address matters of financial control especially in the public sectors towards ensuring effectiveness and control (Al-Mudhaki & Joshi, 2004; Turley & Zaman, 2004). According to Auditing Standard ASA 315, (2006:30), improving the effectiveness of the audit committee will ensure the consolidating all the internal control processes with the public sector (Montondon, 1995). The effectiveness of such committee can only be measured in terms of how far control matters are dealt with from time to time by various public sector organizations (Quigley, 2012). In this vein, audit committees are created to strengthen internal controls and functions on all financial matters (David, 2009).

According to the Auditing Standard ASA 315 (2006:16), by understanding the environment and the pressures the organization and its management are facing, the Audit Committee can evaluate whether risks are being identified and, most importantly, being mitigated. Such an approach enables the committee to exercise its responsibilities in an active rather than a reactive manner and minimizes surprises. An effective control environment needs more than good controls; it needs competent oversight. The board of directors, management, the internal auditors, external

auditors, and the Audit Committee as a whole, each have a role in helping to ensure that an effective control environment exists.

The Audit Committee (AC) receiving enough information to review, understand and assess the department's system of internal controls, the AC making enquiries of the external auditor and management on the experience and sufficiency of staff in the finance and internal audit departments, the AC reviewing the Internal Audit plan annually, the AC reviewing the management letters written by the Internal Audit unit and the Auditor-General, to ensure that all significant matters raised are properly addressed, the AC reviewing the management responses to the above management letters, the AC assessing both the compliance effectiveness and the value of service of the Internal audit department, the AC's orientation programme to educate new members on their responsibilities, the AC participates in a continuing education programme to enhance AC members' understanding of relevant accounting and reporting areas, management, the Auditor-General, and internal audit provide input on the AC charter and meeting agendas, AC meetings are scheduled to allow enough time to cover all agenda items, the AC discusses significant issues with management and the Auditor-General prior to annual financial statement release, the AC reviews significant issues with management and the Auditor-General prior to annual audit report release, and finally, the AC is informed of communications received from governmental or regulatory agencies or similar parties relating to areas of alleged violations or non-compliance.

### 3. METHOD

Quantitative research is generally used with a deductive approach where data is collected to test a theory (Saunders et al., 2012:162). This study sought to investigate the effectiveness of Audit Committee in local government with reference to eThekweni Municipality whereby questionnaires became the choice of data collection of 20 participants. The benefits of the quantitative approach are that the results are generalizable to the entire population (Saunders et al., 2012:163).

Nevertheless, a mixed method combines both the quantitative and qualitative approaches in research design (Saunders et al., 2012:166) whereby, both structured and unstructured questionnaires were used to collect data as well as reviewing audit documents, Audit Committee Charter, minutes of meeting, among others, in order to gain more insight into process and procedures. This will enable the researchers to increase the reliability and validity of

the findings (Saunders et al., 2012:166).

The target population were all Audit Committee members totalling 20. Therefore, this study took a census approach as all the 20 members responded to the structured and unstructured questionnaire. The researchers made contact with all prospective respondents through telephonic conversation, inviting them to participate in this study, followed by which an email was sent to each participant with a letter explaining the purpose of this study. The IBM SPSS 22, was used to analyse the data whereby, raw data was coded and categorised for ease of capture. Each questionnaire received was evaluated for completeness prior to capture into SPSS and content analysis was used to evaluate the data gathered from minutes, Audit Committee charter and terms of reference.

### 3.1. Elimination of bias

Bias occurs when a systematic error is presented in sampling or testing by researchers to influence results so as to generate a particular outcome. By utilising the quantitative research approach for this study, the researchers endeavoured to eliminate bias totally as indicated by Shuttleworth (2009). The researchers additionally structured the questions in a way that was neutral or impartial and avoided leading questions to confuse respondents.

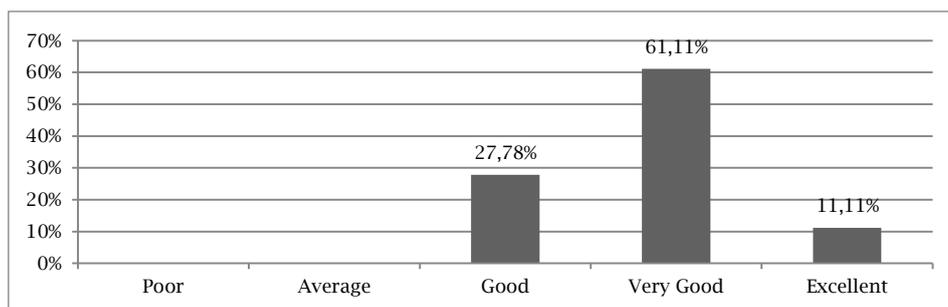
### 3.2. Construction of the instrument

The relationship between an effective Audit Committee and infusion of good control environment was the focal point of the questionnaire, which provided instructions on how to fill it to facilitate completion. A 5-point Likert scale using 1 (poor) to 5 (excellent) and the yes/no questions were administered for data collection and analysis. The structured and unstructured questions, as well as open-ended questions as indicated by Palys (2008), were appropriate for this study because of its nature.

### 4. RESULTS AND DISCUSSION

Questions 1 (The Audit Committee receives enough information to review, understand and assess the department's system of internal controls), Q3 (The Audit Committee reviews the Internal Audit plan annually) and Q5 (The Audit Committee reviews the management responses to the above management letters) follow similar patterns depicted in Figure 1 below whereby respondents had no say regarding the poor and average categories of choices.

Figure 1. The Audit Committee receives enough information to review



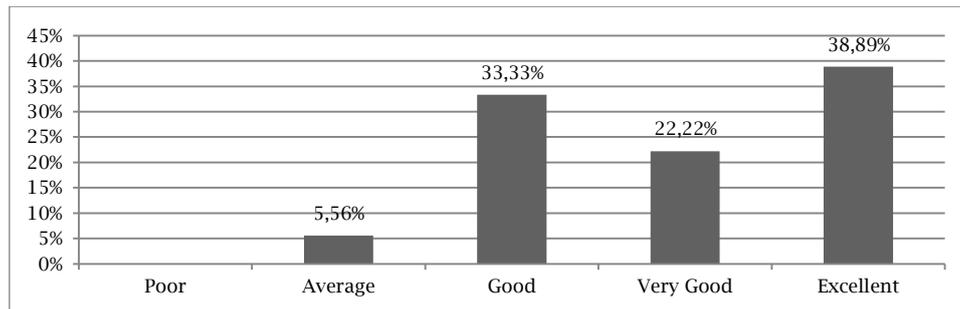
In Q.1, the majority (61%) of respondents rated the activity as Very Good. 28% rated it as Good and 11% rated the activity as Excellent. The overall findings suggest that the Audit Committee receives enough information to review and understand how to assess the organisations' system of internal controls (King III, 2009). The outcome for Q.3, however, illustrates that there is an equal split between the respondents in terms of those who rated the statement Good (42%) and those who rated it Very Good (42%). A small proportion of 18% rated it Excellent. In essence, the findings portray that the Audit Committee reviews the Internal Audit plan on annual basis to provide an oversight role to Internal Audit as recommended by (King III, 2009). The findings in Q.5 nonetheless indicate that 50% rate the issue as Very Good, 33.33% as Good and only 16.67% as Excellent performance to corroborates the findings from the King III Report which shows that the role of the Audit Committee should include reviews of the management responses to findings raised by Auditors (King III, 2009).

Q.2 The Audit Committee makes enquiries of the external auditor and management on the experience and sufficiency of staff in the finance and internal audit departments) reveals that 77% of the participants rated the statement as Poor and 23% as Good without any vote for the other categories.

This indicates that the Audit Committee does not inquire from the External Auditors and management on the experience and sufficiency of employees. According to King III (2009) the Audit Committee is responsible for recommending the appointment of the external auditor and overseeing the external audit process; therefore, they should inquire on the experience and sufficiency of staff from the external auditor, management and internal audit departments.

Another interesting pattern, observed from the study was on Q.4 (The Audit Committee reviews the management letters written by the Internal Audit unit and the Auditor-General, to ensure that all significant matters raised are properly addressed), Q6 (The Audit Committee assesses both the compliance effectiveness and the value of service of the Internal Audit department), Q8 (The Audit Committee participates in a continuing education programme to enhance Audit Committee members' understanding of relevant accounting and reporting areas) and Q9 (Management, the Auditor-General, and Internal Audit provide input on the Audit Committee charter and meeting agendas) as shown in Figure 2. The respondents found no poor ratings regarding all these questions but different scores for the other categories.

**Figure 2.** The Audit Committee reviews management letters



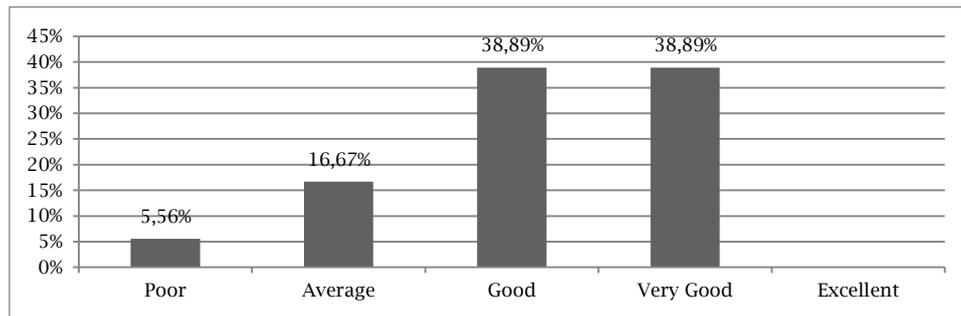
It is reflected in Figure 2 that 33% rated the process as Good and 22% as Very Good. On the other hand, 39% of the respondents feel that the Audit Committee is Excellent in reviewing management letters with only 5.56% scoring on average. The overall findings suggest that the Audit Committee reviews management letters. In terms of MFMA, External Auditors is the Audit Committee's responsibility to ensure that all weaknesses identified by Auditors are resolved by management to improve the quality audit's outcomes. Q.6 indicates that 50% of the respondents rated the statement as Very Good, 33.33% as Good and 11% as Excellent. The remaining respondents of 5.56% again constituted an Average opinion. The overall findings suggest that the Audit Committee assesses both the compliance and effectiveness and the values of service provided the Internal Audit function as per the International Standards for the Professional Practice of Internal Auditing.

Regarding Q.8 however, 50% saw this as an Average practice while 11% rated it as Good. 28% rated it Very Good and the remaining 11% rated it as Excellent. The literature shows that the development of the Audit Committee members is critical in order

to ensure that committee members remain informed about current issues and practices. The findings support this view. It is prudent for the Audit Committee members to receive on-going education about the activities and operations of the organisation, as well as professional development (King III, 2009). In Q.9, a total of 56% rated their statement as Very Good, while 11% rated it as Excellent. 6% rated the statement as Good. The remaining 28% rated it as Average. The average suggests that Audit Committee does encourage input on the Audit Committee charter and meeting agenda from internal audit, and management as it is suggested. (King III, 2009)

Q.7 (The Audit Committee has orientation programme to educate new members on their responsibilities), Q12 (The Audit Committee reviews significant issues with management and the Auditor-General prior to annual audit report release) and Q13 (The Audit Committee is informed of communications received from governmental or regulatory agencies or similar parties relating to areas of alleged violations or non-compliance) also exhibited a similar outcome like Figure 3.

**Figure 3.** The Audit Committee's orientation programme

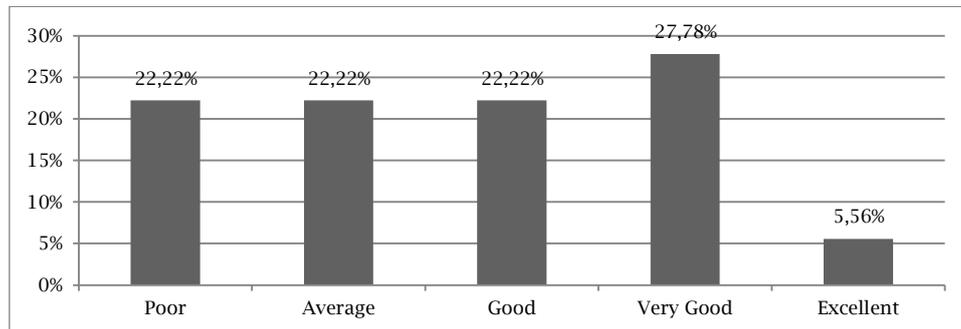


All three questions had no scores for excellent. Figure 3 for Q.7 indicates that 39% observe this process to be Good and 39% as Very Good. It was also noted that 17% of the respondents rated the statement as Average whereas 6% of responses stated it to be Poor. The literature suggests that Audit Committee members must obtain orientation and education before they assume their responsibilities and that it is important for the Audit Committee members to have an on-going education about their duties and operations of the organisation, as well as professional growth (King III, 2009). The majority of the findings are in agreement with this. Q.12 reveals that 55.56% rated this practice as very Good; 33.33% as Good; 5.56% as

Average; and 5.56% as Poor. There is a general consensus that significant issues are discussed by the Audit Committee (King III, 2009). Lastly, Q.13 indicates that 16.67% rated this practice as Very Good; 44.44% as Good; and 38.89% as Average. In terms of PMFA it is essential that the council complies with applicable laws and considers adherence to nonbinding rules, codes and standards. This should form an integral part of the council's risk management process. The findings show a sizeable gap in this practice.

Question 10: Audit Committee meetings are scheduled to allow enough time to cover all agenda items.

**Figure 4.** Audit Committee meetings are scheduled to allow enough time to cover all agenda items



The results suggest that stakeholders are not entirely happy with the length of the Audit Committee meetings to cover all agenda items; this is further noted in Question 10 where the results suggest that a small portion of the respondents also feel that the number and length are not sufficient to adequately cover the meeting agenda. Meetings

should be sufficient in time to cover all agenda items. The Audit Committee's agenda should dictate the scope of duties and complexity of the organisation's operations (King III, 2009).

Q.11: The Audit Committee discusses significant issues with management and the Auditor-General prior to annual financial statement release.

**Figure 5.** The Audit Committee discusses significant issues

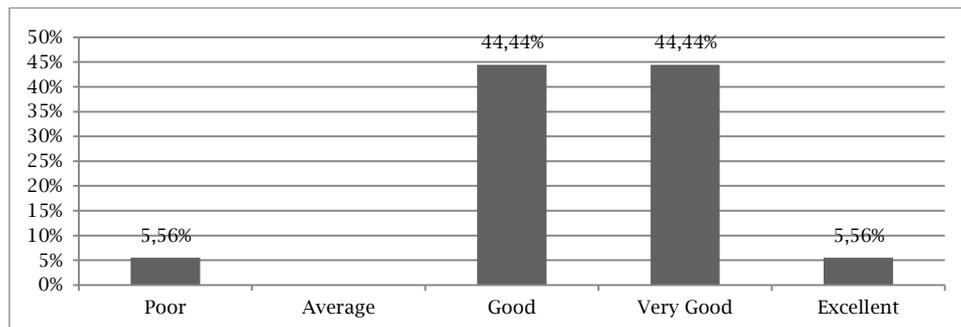


Figure 5 shows that 44.44% of respondents agree (Good) that the AC discusses significant issues. 44.44% rate it as Very Good, 5.56% as Poor and 5.56% as Excellent. The overall findings portray that the discussion of significant issues with management and the Auditor-General prior to annual financial statement release does occur which is in accordance with the best practice. The Audit Committee should monitor the Auditor-General progress and should go through significant findings and produce recommendations to management.

## 5. CONCLUSION

This study noted that all the respondents did not want to comment on the open-ended portion of the study despite enormous assurances of confidentiality and anonymity. As there is a limited body of knowledge on the Audit Committee in local government of eThekweni Municipality, the study used information on the public sector i.e. national and provincial government and private sector as a basis for investigation. At the present moment, there is only a single piece of legislation, the Municipal Finance Management Act (MFMA) that addresses the Audit Committees environment in local government of this area. However, there is a principle relation between local government and both national and provincial government legislation. The unavailability of key informants, such as the Municipal Manager (MM), Chief Financial Officer (CFO), some Audit Committee members, senior management, as well as secretaries, for fear of victimisation, constitute a challenge to the reliability of information received.

It has been noted that the Audit Committee has no direct influence on the achievement of the municipality's mandate. For service delivery to take place, it is dependent on a good control of the environment, which the Audit Committee must monitor and enhance. The attendance of municipal managers at all Audit Committee meetings should be made mandatory. The Municipal Manager as accounting officer is responsible for the administration of the municipality including financial management and compliance. The municipal manager must only attend the Audit Committee meetings as an observer and should not vote or take part in resolutions; the Audit Committee can recuse the municipal manager when dealing with matters where the Audit Committee is of the opinion that his or her presence could compromise the process.

The aspect of constant communication with the internal and external auditors is vital for the effective functioning of an Audit Committee. The informal discussions with the external auditors contribute towards an on-going mutual understanding between the Audit Committee and the external auditors on matters relating to the operations of the municipality and financial reporting requirements. Audit Committees should have a schedule of meetings for the whole financial

year. There should also be regular communication between the Audit Committee chairperson, the municipal manager and the mayor. The research showed that the attendance of senior management also had an effect on the performance of the Audit Committee. The Audit Committee should ensure that all relevant managers attend meetings on the invitation to respond to questions relating to their departments. They could be recused when necessary.

The Committee should hold sufficient, scheduled quarterly meetings to discharge all its duties as set out in the terms of reference. A structured orientation programme should be presented to all new members to induct and inform them about the activities and functions of the municipal local government. Municipality officials particularly the CFO's and Heads of Internal Audit should create forums for discussions, exchange of ideas and share experiences. This should preferably be done every quarter.

The Audit Committee should put mechanisms in place to ensure it receives sufficient information to review and understand the municipality's system of internal controls, as this area is a cause for concern as per the findings. The Audit Committee should encourage the municipal manager and the mayor to have a specific budget for an internal audit and to appoint permanent staff or outsource internal audit assignments. The Audit Committee through the internal audit units needs to regularly review recommendations of best practice as that of the Institute of Internal Auditors, so as to incorporate the recommendations in their functioning.

It is disturbing that participants (77%) indicated that the Audit Committee does not enquire from the External Auditors and management about the experience and efficiency of employees. This could be because they see it as immaterial, given the fact that there is a shortage of people with financial skills and technical expertise to man these roles. The good news, however, is that a total of 50% of the respondents saw this as an average practice while 11% rated it as Good; 28% rated it Very Good and the remaining 11% rated it as Excellent. Since 50% are of the view that this is average, it means they appreciate the challenge of getting skill personnel for these jobs and therefore, have no problem with the practice. The literature shows that the development of the Audit Committee members is critical to ensure that committee members remain informed about current issues and practices. The Government, through the ministry of education, will do well to step up the production of Auditing graduates to man this all-important task in the country. Regarding the respondents who did not want to comment on the open-ended portion of the study despite enormous assurances of confidentiality and anonymity, this is regrettable as this could skew the outcome of the study towards one direction.

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