

The Role of Internal Audit Functions at State Owned Enterprises in South Africa

LJ Mamaile

University of South Africa, South Africa

Abstract: This paper was undertaken to assess the role of internal audit functions in South African State owned enterprises. The state owned enterprises (SOEs) in South Africa have been on the spot light for quite long, with these enterprises failing among other things to obtain positive audit outcomes, self-sustainability and corruption allegations. All these proved to be unfolding despite the internal audit functions (IAFs) being in place. Although IAFs are instruments with the expertise to assess efficient utilisation of financial resources within the SOEs and could help them to improve oversight and financial performance, research has paid little attention to the role of IAFs in the financial management process. As a result, the SOEs in South Africa have been obtaining negative audit outcomes from the Auditor General South Africa (AGSA) over the years. This paper relied on AGSA reports in establishing what role the internal audit functions play in the SOEs in South Africa and whether they have any role to play in assisting them to obtain the desired audit outcomes. Therefore, the data was collected from the AGSA audit reports for the period of five years, being the period from 2014/2015 to 2017/2019 financial years. The results of the paper suggest that IAFs appear to be playing an important role in SOEs in South Africa, however, they have no power to enforce their report findings as the oversight structures appear to be ineffective. Therefore, this paper further suggests that the oversight structures such as audit committees need to be strengthened for the IAFs to be effective and value adding.

Keywords: Audit committees, Internal audit functions, State owned enterprises, Value-adding

1. Introduction

The Constitution of the Republic of South Africa puts the responsibility for the delivery of certain public goods and services for the benefit of the citizenry on state owned enterprises (SOEs), subject to the availability of resources (Constitution, 1996). However, there seems to be a general consensus that there is still a long way to go to reach these delivery targets and to achieve the excellent performance expected by the SOEs. Where a delivery commitment is made, hopes are raised. Where delivery does not progress accordingly, the affected people lose hope and the scene is set for protests and violence, as has become common in South Africa (Putu, Mimba, Van Heden & Tillema, 2007).

The fact that South Africa has a well-developed infrastructure in comparison to other African countries, an excellent financial system and sound governance policies and constitution, including good mixture of both private and public sector economic system, therefore, SOEs still remain an essential strategic tool for the state to drive service delivery, create employment and generate economic value. These developmental objectives can be achieved if the

state ensures that there is greater accountability, enhanced financial responsibility, and better performance management by the SOEs, therefore, the SOEs have an important role to play in the country and its development. However, a number of SOEs in South Africa proved to be continuously under-performing against expectations (Mankins & Steele, 2005; Putu, Mimba, Van Heden & Tillema, 2007; Brand, 2019). Some of the challenges faced by the SOEs in South Africa include the following:

- The Independent Development Trust (IDT) received a qualified audit opinion in 2013-14 and subsequently received disclaimed opinions in the 2014-15 and 2015-16 financial years after deficiencies were identified in management's processes to appropriately account for programme expenditure (AGSA, 2019).
- The SABC regressed from a qualified opinion to an adverse opinion and the Courier and Freight Group (a subsidiary of Sapo) retained its previous year's adverse opinion – both had various material misstatements in their financial statements and could not substantiate that they are going concerns (AGSA, 2019). For

example, the irregular expenditure of audited state-owned enterprises increased five-fold to R27bn, according to the Auditor General's report for the 2017/18 financial year (AGSA, 2018).

- Fruitless and wasteful expenditure increased by more than 200% from the previous year to R2.5bn in 2018. Irregular expenditure continues to remain high at R51bn. The Auditor General indicated that the total included the irregular expenditure of those auditees for which the AGSA had completed the audits after the cut-off date of the report (R5.4bn) (AGSA, 2018). "Considering that most of the SOEs where audits had not yet been completed are facing going-concern challenges, the financial outlook for most SOEs is bleak," (AGSA, 2018).

The challenges go further as a number of SOEs were found with high amount of irregular expenditure as indicated below, the main contributors were the following (AGSA, 2019):

- Airports Company South Africa (ACSA): R1 169 million (2015-16: R134 million) – 60% was as a result of non-compliance with legislation on contracts;
- South African Post Office (SAPO): R719 million (2015-16: R127 million) – 45% was as result of non-compliance with procurement process requirements and 37% as a result of not following competitive bidding or quotation processes; and
- South African Broadcasting Corporation (SABC): R687 million (2015-16: R764 million) – 75% was a result of not following competitive bidding or quotation processes.

Sambo (2019:121) states that auditors including the IAFs are increasingly finding it difficult to conduct their audits, whereby, among others, some public institutions such as SOEs placed pressure on auditors to misrepresent audit outcomes as well as not disclose irregular expenditure.

Chauke (2019:606) states that the recent years' ethical scandals that have manifested themselves in the SOEs, have become common, the similar situation was also observed on a number of top management executives of corporate giants like Arthur Anderson, Lehman Brothers and WorldCom

in the United States, Satyam Computer Services of India amongst others. Steinhoff in South Africa, for instance, grew throughout five decades to become one of the largest companies in the country (Agbin, 2018:20-21; Naude, Hamilton, Ungerer, Malan & de Klerk, 2018:15-21) which was also found in ethical dilemma.

Through the help of the IAFs with the internal auditors that are well trained, the IAFs can play a significant role in assisting their SOEs in addressing the deficiencies, scandals and challenges facing these enterprises. It is expected that the professionally independent IAFs should report their audit findings to an unbiased audit committee, which should oversee any necessary implementations. Once the IAFs are able to identify and report the findings to the effective audit committees, the SOEs can easily mitigate challenges in all areas and end up achieving positive audit outcomes from the AGSA.

The Institute of Internal Auditors (IIA) (2018:10) describes the IAF as a crucial internal assurance mechanism in public financial controls and a tool for monitoring and evaluating managerial activities prior to evaluation by external auditors. Internal auditors further enhance transparency and fairness, reduce corruption, and ensure value for money in public procurement. An IAF is an essential part of any public expenditure management system and should ensure that public spending is within budgetary provisions and that payments comply with specified procedures, as well as providing for the timely reconciliation of accounts and effective systems for management and accounting of physical and financial assets. Therefore, the role played by IAF is undoubtedly crucial for any SOE and if the role is fully played positive audit outcomes could be achieved. This paper aims at determining the role the IAF can play in ensuring that their SOEs obtain positive audit outcomes. This paper was motivated by the need to provide the link between the IAF and the state of SOEs in the public sector since existing literature has neglected this important area.

Based on the discussion above, it is evident that the SOEs have a crucial role to play in South Africa and if such role is well played the government can achieve its objectives. However, it was highlighted above that there are various challenges ranging from negative audit opinions, corruption, maladministration and scandals experienced by these enterprises, despite having the IAFs in their disposal. This raises

Table 1: Imposed Coding Scheme for AGSA Reports

Focus area	Main categories	Code assigned in AGSA's reports	Code descriptor
What are the main roles of the IAFs in the SOEs according to AGSA.	<ul style="list-style-type: none"> Internal audit units Role of internal audit unit 	Internal audit role	Any statement or segment in the AGSA's reports which indicate the role the internal audit unit should play or expected to play

Source: Researcher's own analysis

the problem that needs to be investigated in this paper of: what role do the internal audit functions play in the state owned enterprises?

The following section contains a discussion of the research problem, research methodology reviewed for this paper. Subsequent sections outline the research results and provide conclusions and recommendations for further studies.

2. Method and Materials

This paper adopted a qualitative research method to explore the role played by the IAFs in the SOEs in South Africa. The data was collected from the AGSA audit reports for the period of five years, being the period from 2014/2015 to 2018/2019 financial years with the assistance of Atlas.ti software. These data were collected from all the SOEs' annual reports. The AGSA audit reports were coded using the concept-driven and data driven approach. In both the concept-driven approach and data driven approach, a coding frame was developed which was imposed to all the SOEs' annual audit reports as per AGSA. The analysis was only done on internal audit units. In analysing the AGSA's annual reports the focus was on what are the main roles of the IAFs in the SOEs according to AGSA. As shown in Table 1 above the following coding scheme was used.

3. The Expected Roles of the Internal Audit Functions and the Challenges Faced by SOEs in South Africa

3.1 The Expected Role of the Internal Audit Functions

The International Professional Practices Framework (IPPF) defines internal auditing as "an independent, objective, assurance and consulting activity designed to add value and improve an organisation's operations (IIA, 2014). It helps an organisation to accomplish its objectives by bringing a systematic,

disciplined approach to evaluate and improve effectiveness of risk management control and the governance process". This definition emphasises the aim of IAFs in all organisations, being to "add value" within organisations, and further indicates how effectiveness can be enhanced.

Based on the definition above, the IAFs should contribute to reducing risk exposure. In order to reduce the risks identified, the IAFs needs to determine what areas of difficulty that can prevent the accomplishment of the organisations' stated objectives and also assess the controls that are in place to determine whether those controls are suitable and acceptable in light of the risks identified (Sawyer, Dittenhofer & Scheiner, 2008:141-142).

According to the Standards (Institute of Internal Auditors, 2014), the IAFs must evaluate the adequacy and effectiveness of controls in responding to risks within the organisation's governance, operations and information systems regarding the reliability and integrity of financial and operational information, the effectiveness and efficiency of operations, safeguarding of assets, and compliance with the laws, regulations, and contracts. De la Rosa (2007:52) further argues that IAFs are responsible for the evaluation of the accuracy of an organisation's risk management reporting, and should provide independent and value-adding recommendations to management. Firstly, the IAFs are adding value by responding to the risk impact through communication, controls, and contingencies (Pickett, 2005:59; Hermanson, Ivancevich & Ivancevich, 2008:14). Secondly, the definition of value-added indicates that IAFs add value by rendering both assurance and consulting services. If all the functions discussed above are fully rendered, the SOEs will be able to operate smoothly and positive audit outcomes will be achieved.

The Institute of Internal Auditors (2012:10) further describes IAF as an important internal assurance

instrument available in public financial controls, and as a device that can be used for monitoring and evaluating managerial activities before an audit is conducted by external auditors. Internal auditors are viewed as professionals who can boost openness and justice, decrease dishonesty, and ensure value for money in public spending (Institute of Internal Auditors, 2014).

According to Morse (2012:2), a good IAF should be the "eyes and ears" of senior management; giving honest and clear information about organisational affairs. Marks (2013:1) further states that the IAF becomes effective if it provides the audit committee (AC) and executive management with the assurance they need, namely, that they can depend on the organisation's processes and systems to manage risks towards the accomplishment of the organisation's objectives. This means that the IAFs must provide assurance by examining the current risks faced by the state owned enterprises and suggest the suitable solutions. Ackermann (2015:272) supports this notion by stating that IAF can only be regarded as adding value, ethical and competent in its core technical areas if it provides a product (report) which is informative, persuasive and calling for action. Based on the discussion above, it is evident that the IAFs are expected to play an important role in their organisational survival and should therefore, be properly supported by those in management and the audit committees in which they report their work.

Barac, Plant and Motubatse (2009:983) further argued that the IAFs should identify operational improvement. This is echoed in the definition of internal auditing, which highlights that the IAF's activities should contribute to the improvement of the organisation's operations (IIA, 2014). According to the IIA Standards, the IAF must evaluate and contribute to the improvement of, specifically, governance, risk management and control processes, systems, and operations (IIA, 2014; Motubatse, 2019).

3.2 Regulations of Internal Audit

The existence of internal audit function in the South African public sector organisations is required in terms of section 38 of the Public Finance Management Act 1 of 1999 and the Section 165 of the Municipal Finance Management Act No.56 of 2003. The internal audit function is further strengthened by the internal audit framework of the public sector (RSA,

2004) which provides the minimum guidelines for the development and operation of internal auditing in the public sector. This framework provides guidance to the IAFs in the public sector to ensure that the IAFs comply with the PFMA and the constitution.

3.3 The SOEs in South Africa

The SOEs are established by governments worldwide to solve capital market failures among others and deliver critical public goods, such as electricity, education, health, transport and road infrastructure services that are too costly for the private sector (Linna, Pekkola, Ukko & Melkas, 2010:48). These entities are mixed in their nature due to the fact that they are profit-driven while they have to contribute to the developmental goals of the state. Their primary mandate is to serve as catalysts for growth and development of the economy, including creating employment opportunities on behalf of the state (Jurkonis & Petrusauskaitė, 2014).

In South Africa, SOEs are legal entities in terms of the Companies Act of 2008, are regulated under the PFMA, and they are mandated to pursue both commercial and development undertakings on behalf of the state. SOEs are funded by the National Treasury, which generates their revenue mainly from the South African Revenue Services (SARS), therefore the South African public, as the indirect shareholders in these entities, have a vested interest in how these funds are utilised.

South Africa at the moment has a number of SOEs which contribute approximately 9.2% of the Gross Domestic Product (GDP) (MoneyWeb, 2013). South Africa's SOEs operate in key strategic industries, with the likes of ESKOM, South African Airways (SAA), the South African Broadcasting Corporation (SABC), DENEL, Public Investment Corporation (PIC), IDC, Armscor, Acsa, PetroSA and Transnet to mention but a few. For the purpose of fulfilling the demands and hopes of the stakeholders, SOEs must be both efficient and effective in discharging their responsibilities (Mihaiu, Opreana & Cristescu, 2010) and they must maximise the use of the resources at their disposal to ensure that the state objectives are realised.

3.4 The Challenges Faced by SOEs in South Africa

Table 2 on the next page presents a summary of SOEs' performance results over a three-year period (2017-2019).

Table 2: SOE's Financial Performance Over Three Years' Period

Profit/Loss (Rm) made by SOEs in 2017 - 2019			
SOEs	2017	2018	2019
Airports Company South Africa (Acsa)	2 005	842	504
Armscor	-127	2	235
Broadband Infraco	-127	-113	-14
DBSA	2 821	2 283	3 097
Denel	282	-1 084	-1 749
Eskom	-4 608	-2 337	-20 729
Industrial Development Corporation (IDC)	2 200	3 224	720
Land Bank	367	254	181
PetroSA	-1 608	-676	-1 575
Public Investment Corporation (PIC)	533	411	301
South African Post Office	-967	-908	-1 174
Passenger Rail Agency of South Africa (Prasa)	-928	1 442	-1 685
South African Broadcasting Corporation (SABC)	-1 040	-744	-482
Transnet	2 765	4 851	6 047

Source: Moneyweb (<https://www.moneyweb.co.za/news/south-africa/soes-results-proof-of-massive-problems/>)

The majority of the SOEs as shown in Table 2 above had under-performed for a three-year period (2017-2019), with Eskom's results showing the biggest loss of more than R20 billion. 67% of these SOEs reported immensely worse results for the reporting period ending 31 March 2019 as compared to the previous year (Kruger, 2019). These results do not show the full picture because some of these SOEs have not published their results yet. These bad results show that SOEs have been underperforming despite the existence of the IAFs.

Many of these SOEs place their reliance on the state for financial assistance or bail-outs in order to continue in operation, yet at the same time this over-reliance places a heavy fiscal burden on the state (Mail & Guardian, 2017). Despite the continuous bailouts, these SOEs are most times not productive; they are consistently making losses and incurring wasteful expenditure. This has ultimately bred a culture of failure throughout most SOEs (Gumede, 2015). Most concerning, is that this culture has created a notion or belief that, one way or another, SOEs do not necessarily have to be managed as effectively as businesses or private entities in view of the fact that their primary objective is to deliver on social and developmental goals of the state and not make profits.

Madumi (2018) argues that in the last decade, South Africa has witnessed a growing poor performance

from many SOEs, and this has a negative impact on state's resources and stunted economic growth. Madumi (2018) draws attention to the fact that the practise of providing bail-outs to failing SOEs has had a damaging effect on the public purse, owing to the fact that limited cash resources of the state are being drawn away from providing critical public services such as education, health, and housing but are rerouted towards funding inefficiencies, mismanagement of funds and wastage.

Kornai and Weibull (1983) submit that most entities which are in a corrupt state are subjected to the 'softening' of the budget constraint. This concept alludes to the presumption that an entity facing financial hardship will be bailed out if it is part of a larger group of companies. Chang (2007) contends that the "softening" of the budget in a government setting alludes to SOEs being afforded the luxury of securing financing from the state if they are in financial distress and will never have to worry about insolvency because of the guarantee of a bailout from the state. Notwithstanding the fact that the state needs to have these SOEs to implement their developmental mandate, they however, persistently put pressure on the state's economic resources by constantly demanding additional funding. All these challenges continue to be experienced despite the IAFs being in place in these SOEs raising the question: what role do the IAFs play in the SOEs?

3.5 The Role of Audit Committees

According to Motubatse (2019:119) the audit committees fulfil the role of governance oversight in their organisations. They provide oversight of financial reporting processes, systems of internal control, risk management and of compliance with laws and regulations (National Treasury, 2009), they therefore, ensure good corporate governance in their organisations. Sebola (2017) states that governance today seem to have achieved much as a model of management where there is good interaction with stakeholders, whether being internal or external, has been achieved with accountability and transparency being at the fore. One of the roles the AC needs to fulfil is to oversee the work of the IAF, including reviewing and monitoring management's response to internal audit findings and recommendations (Alzeban & Sawan, 2015). Alzeban and Sawan (2015) further provide empirical evidence of a correlation between the characteristics of the AC and their perceptions of the importance of implementation of internal audit recommendations. Another expectation of the AC expectation is identified by the study by Zaman and Sarens' (2013), which examined the factors associated with the pursuit of informal interactions between ACs and IAFs. Zaman and Sarens (2013) found that ACs and IAFs are engaged in informal interactions, in addition to formal prescheduled and regular meetings, and concluded that the informal interactions should complement formal meetings between the audit committee and internal audit functions. Thus, Soh and Martinov-Bennie (2015) concluded that interaction with the IAF is important as it affords opportunity to reassure the AC about the activities of the IAF.

In the South African public administration arena, the duty of an AC is to support and facilitate the attainment of effective governance. (AC in the public sector including the SOEs get their mandate from section 77 of the Public Finance Management Act (RSA, 1999)). Thus, the ACs works together with other assurance providers to ensure that the necessary governance tools are functioning, in order to promote a sound financial management system. Here, the essence of the relationship lies in the effective functioning of internal audit (Chevers, Lawrence, Laidlaw & Nicholson, 2016), because its strength strengthens governance in the public sector (Motubatse *et al.*, 2009). Thus, the AC expects

internal audit to evaluate internal controls and compliance with laws and government regulations (Hegazy & Stafford, 2016). For that reason, audit committees were introduced into the South African public sector as part of its governance systems, to enhance adherence to the principles of financial management, accountability, transparency, leadership, and risk management (IIA, 2014; IOD, 2016). The audit committee thus provides guardianship for all assurance providers, including internal and external auditors.

4. Results and Discussion

The results and discussion are presented hereunder. The data was analysed through the use of Atlas.ti software, this was to ensure that the theme formulated is clearly followed and identified on the voluminous AGSA reports and unbiased analysis can be achieved. The data was analysed by means of coding the collected AGSA's data to allow the identification of themes and subthemes. Coding in qualitative research consists of the assignment of short phrases to capture a meaning of a large portion of textual data (Yin, 2011). Babbie (2013:550) and Saldaña (2009:8) both define coding as "a process of arranging raw data into a standardised form." The process started with a review of AGSA reports for five years' period 2014/2015 to 2018/2019 financial years. While considering the whole context, the data was coded. After concluding the analysis of the AGSA audit reports for the five years' period, the main findings were raised with regard to IAFs in the SOEs in South Africa. Table 3 on the next page presents these findings from the AGSA audit reports.

The IAFs are not in place in all the SOEs. As a result, the ACs and IAFs are not adding their oversight to ensure that controls over financial management, compliance with legislation and performance reporting is put in place. No assurance is provided by the IAFs in the key areas of the financial statements in some instances. A well-resourced IAF is the key in accomplishment of the positive audit results. Failure to address the internal audit findings by SOE's management is the main reason for a lack of positive impact made by the IAFs.

Less utilisation of IAFs has been pointed as one of the challenges facing the SOEs. The IAFs are often not validating the progress reported on action plans against documentation to ensure that the

Table 3: The AGSA Findings Regarding IAFs in SOEs Over Five Years' Period

Financial year	AGSA findings
2014/2015	<ul style="list-style-type: none"> • Internal audit functions were found in place in all SOEs except in eight SOEs. • Audit committees and internal audit functions need to improve their oversight to ensure that controls over financial management, compliance with legislation and performance reporting improve and are embedded. • Internal audit functions were not used to provide assurance on key areas of the financial statements.
2015/2016	<ul style="list-style-type: none"> • The procurement processes could not be audited by either the internal auditors nor investigators. • At most auditees, well-resourced and effective internal audit functions have helped to improve internal controls and have had a positive impact on audit outcomes. We assessed that 249 of the internal audit functions (2015-16: 244) had a positive impact on audit outcomes. The main reason for a lack of positive impact was the failure by management to address internal audit findings.
2016/2017	<ul style="list-style-type: none"> • The internal audit functions and audit committees need to be better utilised for independent reviews of the information reported. • Sustainable processes are not put in place to ensure that the underlying records do not contain errors, while some auditees are still not getting the full benefit from the financial statement and performance report reviews by internal audit functions and audit committees. • The effectiveness of the work performed by the various assurance providers, such as the internal audit function audit committee, provincial treasury and public accounts committee, was hampered significantly by management's failure to implement their recommendations or resolutions.
2017/2018	<ul style="list-style-type: none"> • Compliance checklists were not implemented as a tool to supplement policies and procedures. These will enable officials, supervisors and monitoring units such as internal audit functions to independently check whether all legislative requirements are met in the daily transactional, management as well as SCM processes. • There was no an adequately resourced and functioning internal audit function which is overseen by the audit committee that can identify internal control deficiencies and recommend corrective action effectively. • Internal audit functions did not validate the progress reported on action plans against documentation to ensure that the root causes of findings were being addressed. • Internal audit functions were found reporting directly to management functionally and not to audit committees as required.
2018/2019	<ul style="list-style-type: none"> • The internal controls that should ensure the quality of financial statements and performance reports as well as compliance with legislation were not in place at all SOEs, resulting in negative audit outcomes. • Instability at board and executive levels played a role in the outcomes of SOEs. At the SABC, for example, the board did not quorate for most of the financial year and the interim board was put in place only at the end of the financial year.

Source: Researcher's own analysis

root causes of findings were being addressed. The IAFs were found reporting directly to management, not to audit committees. The internal controls that should ensure the quality of financial statements and performance reports as well as compliance with legislation were not in place at all SOEs, resulting in negative audit outcomes and instability at board and executive levels of the SOEs which often fail to quorate or take necessary decisions.

According to the data gathered through the content analysis. The results revealed that the IAFs are considered to be the most important oversight tool available to SOEs in achieving their objectives, however, management appear to be reluctant in addressing the findings made by the IAFs to improve their functions. The Audit Committees are not supporting the IAFs hence some IAFs were found reporting directly to their management teams

instead of the ACs as expected. Therefore, the IAFs need to strive for their independent and ensure that they work smoothly with the ACs and the ACs should ensure that the atmosphere in the SOEs is the one that will allow the free operation of the IAFs to strengthen governance.

5. Conclusion and Recommendations

It is evident that SOEs are facing a number of challenges in their daily operations, some of these challenges could be resolved by implementing properly functioning oversight structures such as audit committees and internal audit functions. The paper suggests that the IAFs appear to be playing an important role in state owned enterprises in South Africa, however, they have no power to enforce their report findings as the oversight structures appear to be ineffective. The paper further suggests that the oversight structures such as audit committees need to be strengthened for the internal audit functions to be effective and value adding. The findings of this paper will assist the internal audit functions, state owned enterprises, South African government and general public in understanding the role that need to be played by the internal audit functions and the challenges faced by these enterprises in South Africa. It is therefore, recommended that government through its national departments start to strengthen the functioning of the audit committees in the SOEs and ensure that these committees recruit suitable qualified people who can assist these enterprises to operate as expected. It will be beneficial for government to further implement consequence management in those not performing as per the expectations, involved in corruption and maladministration while empowering the IAFs to discharge their functions independently and objectively.

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