A VALUE ADDING INTERNAL AUDIT FUNCTION SUPPORTIVE TO CORPORATE GOVERNANCE FOR GAINING A STRATEGIC ADVANTAGE

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OPSOMMING

Titel: 'n Waardetoevoegende interne ouditfunksie ondersteunend tot korporatiewe beheer vir die verkryging van 'n strategiese voordeel.

Die doel van hierdie studie is om 'n geïntegreerde model vir 'n waardetoevoegende interne ouditfunksie, ondersteunend tot korporatiewe beheer vir die verkryging van 'n strategiese voordeel te ontwikkel.

Studies dui aan dat beleggers bereid is om 'n premie vir aandele van 'n maatskappy te betaal wat goeie korporatiewe beheer het en dat die uitoefening van eienaarskapsbelange 'n bestuursfokus op korporatiewe beheer en prestasie-areas tot gevolg het wat 'n verhoogde opbrengs op belegging lewer. Dit is dus onverstaanbaar dat onlangse opnames aan die lig gebring het dat geen Suid-Afrikaanse maatskappy ten volle aan die vereistes van die King-verslag oor korporatiewe beheer voldoen nie.

Die komponente van 'n waardetoevoegende interne ouditfunksie is bepaal, aangesien 'n moderne funksie noodsaaklik is vir waardetoevoeging. Die tien belangrikste komponente is onafhanklikheid, status, vaardighede, professionalisme, ouditmetodiek, strategiese rigting, risikobestuur, gerusstellingskonsultante, risiko gerusstellingsvennote en prestasiemeting.

Die waardetoevoegings-moontlikhede van 'n moderne interne ouditfunksie is die verbetering van die kontrole-omgewing, bystand van bestuur met die identifisering en verbetering van kontrole- en prestasie-swakhede, verbetering in die kwaliteit van die bestuursproses, verbetering van bestuur se kennis van interne beheer en risikobestuur, verbetering van die voorkoming en opsporing van bedrog en om die onderneming in staat te stel om die nakoming van korporatiewe beheer te demonstreer.

Die belangrikste beginsels van korporatiewe beheer is aanspreeklikheid, kommunikasie, struktuur, doelwitte en strategie, kontrole-omgewing, risikobestuur, etiek, regstellende aksie, omgewingsbestuur en werknemerdeelname.

Verhoging van aandeelhouerswaarde en gerusstelling van belanghebbers is geïdentifiseer as strategiese voordele voortspruitend uit korporatiewe beheer.

Daar is bevind dat al die komponente van 'n waardetoevoegende interne ouditfunksie teenwoordig moet wees om waarde toe te voeg. Interne oudit moet die volle spektrum van dienste lewer om korporatiewe beheer te steun. Al die beginsels van korporatiewe beheer moet in plek wees om strategiese voordele te verkry.

'n Model is ontwikkel wat die integrasie van bogenoemde aandui.

SUMMARY

Title: A value adding internal audit function supportive to corporate governance for gaining a strategic advantage.

The aim of this study is to develop an integrated model for a value adding internal audit function, supportive to corporate governance, for gaining a strategic advantage.

Studies indicate that investors are willing to pay a premium for shares of a company with good governance and that the exercising of ownership interests focus management on corporate governance and performance issues resulting in an increased return on investment. It is thus difficult to comprehend recent surveys indicating that no South African company fully comply with the requirements of the King Report on corporate governance.

The components of a value adding internal audit function were established, as a modern internal audit function is required to add value. The ten most significant components are independence, status, skills, professionalism, audit methodology, strategic direction, risk management, assurance consultants, risk assurance partnering and performance measurement.

The value adding abilities of a modern internal audit function are enhancing of the control environment, assisting management with the identification and improvement of control and performance weaknesses, enhancing the quality of the management process, improving management's understanding of internal control and risk management, enhancing fraud prevention and detection and enabling the demonstration of corporate governance compliance.

The most significant corporate governance principles are accountability, communication, structure, goals and strategy, control environment, risk

management, ethics, affirmative action, environmental management and worker participation.

Enhancement of shareholder value and stakeholder assurance were identified as the strategic advantages to be gained from corporate governance.

It was established that all the components of a value adding internal audit function must be present to deliver value. Internal audit must provide the full spectrum of value to support corporate governance. All the corporate governance principles must be embraced for the gaining of strategic advantages.

A model has been developed demonstrating the integration of the abovementioned.

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CHAPTER 1

BACKGROUND AND RATIONALE

1.1 Introduction

The strategic advantages of good corporate governance are of significant interest. A study by McKinsey & Company to discover how shareholders value corporate governance in various markets, indicates that investors are prepared to pay a premium for shares of companies maintaining high corporate governance standards (McKinsey & Company, 2000). CalPERS found that active exercising of ownership interests focuses management on corporate governance and performance issues which results in increased returns on investment (CalPERS,1996). The Cadbury Committee was established in the United Kingdom because of the perception that Anglo-American companies were lagging behind in global competitiveness and concerns over significant corporate failures arising from fraud (Cadbury, 1992). Internal audit has been an accepted practice in most affected corporations for a considerable time. Corporate governance is becoming a familiar term, although few companies, none in South Africa, comply in full with relevant corporate governance requirements of the King Report on corporate governance (KPMG, 1998). Internal audit's role of enhancing efficiency and effectiveness and providing assurance on effectiveness of internal control, risk management and compliance with policies, procedures and regulations supports the achievement of corporate governance objectives.

Internal audit has traditionally been viewed as management's “watchdogs”. Similar to recent corporate governance experiences, internal audit functions too often exist for “window dressing” purposes, rather than to optimise the value adding capabilities of internal audit. The emergence of corporate governance challenged internal audit's efforts over many years to break away from its traditional “watchdog” role to evolve into a value adding service of note. Although a positive move is generally experienced, too many functions still retain their traditional status or are outsourced to external audit firms. The growth in outsourced internal audit services to external audit firms confirms the importance of internal audit's value. A modern, value adding internal audit function is required to support and enhance high corporate governance standards.

Corporate governance is too often viewed as an unnecessary set of rules with resultant increased costs, adversely affecting creativity and cost competitiveness in an environment where affected companies compete with companies not falling under the auspices of the King Report. In preventing penalties or a negative stakeholder reaction these companies pay lip service to corporate governance with partial compliance in areas where it suits them. They pretend to agree with the principles of corporate governance for window dressing purposes only, rather than utilising the full value of corporate governance to gain a strategic advantage in the market place.

The inherent value adding ability of a well-structured internal audit function, that enjoys management support, could be the starting point to support full compliance with corporate governance. Internal audit and corporate governance should thus not be considered independent of each other, as the one could not effectively exist without the other, and an integrated approach is required.

1.2 Aim

The aim of the study is to develop an integrated model of a value adding internal audit function supportive to corporate governance for gaining a strategic advantage. Sub-objectives have been developed to achieve the aim of the study. These relate to the internal audit function and corporate governance as described below.

1.2.1 The internal audit function

The components of a value adding internal audit function and the value adding abilities of the modern internal audit function will be determined. The reasons for failure of internal audit functions will also be established.

1.2.2 Corporate governance

The most significant principles of corporate governance and the strategic advantages to be gained from adhering to these, will be determined. The reasons for corporate governance failure will also be established.

1.3 Research methodology

The methods of research will be literature studies complemented by structured interviews.

1.3.1 Literature study

The literature study will focus on the characteristics of a modern internal audit function. The study will aim to identify the components and value adding abilities distinguishing between a modern internal audit function and a traditional function. Specific emphasis will be placed on those aspects that can be supportive to corporate governance principles for gaining a strategic advantage. The study will also consider the reasons for ineffective functions.

Various reports on corporate governance will be studied of which the most important being the King Report, due to its South African relevance and the Turnbull Report, as it is widely viewed as best practice. The most important principles will be studied with a specified view as to how these will be supported by the internal audit function. Cognisance will be taken of principles which investors will regard as significant and thus gain a strategic advantage.

1.3.2 Structured interviews

A structured interview framework will be developed to obtain information and views from experts in their particular fields. Information regarding the value adding abilities of internal audit and the strategic advantages to be gained from corporate governance will be seeked. Interviewees will also be questioned regarding failures of internal audit, corporate governance and specifically, their views on how internal audit could support corporate governance. The structured interviews will be used to complement information gained from the literature study and to fill gaps where more information is needed. The most significant gaps appeared in determining which value-adding abilities of internal audit support which corporate governance principles and what the related strategic advantages will be. An example of the structured interview framework and curriculum vitaes of interviewees are attached as Annexures A and B respectively.

1.4 Meaning of key terms

1.4.1 Affected corporations

This is the terms used for organisations in South Africa to which the recommendations of the King Committee on corporate governance apply. King (1994:5) defined affected corporations as follows: "All companies listed on the main board of the Johannesburg Stock Exchange, large public entities as defined in the Public Entities Act, banks, financial and insurance entities as defined in the various Financial Services Acts, large unlisted dependent companies, large quasi-state entities such as control boards and co-operatives".

1.4.2 Corporate governance stakeholders

The following stakeholders have an interest in corporate governance:

- Shareholders
- Employees
- Bankers
- Suppliers
- Customers
- Environmentalists
- Community
- State.

1.5 Chapter layout

Chapter 2 will provide a basic theoretical overview of internal audit.

Chapter 3 will consist of a theoretical overview of corporate governance and discussion of aspects that can result in gaining a strategic advantage. Specific strategic advantages will be briefly discussed.

The results of the structured interviews will be summarised and discussed in chapter 4.

A model integrating internal audit and corporate governance for gaining strategic advantages will be developed based on the literature study and structured interviews and will be reflected in chapter 5. Chapter 5 will also reflect concluding remarks.

CHAPTER 2

INTERNAL AUDIT

2.1 The definition of internal audit

The Institute of Internal Auditors (Internal Auditor, 1999:29) defined internal audit as follows: "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."

Sawyer (1996:6) offered the following: "Internal auditing is a systematic, objective appraisal by internal auditors of the diverse operations and controls within an organisation to determine whether (1) financial and operating information is accurate and reliable, (2) risks to the enterprise are identified and minimised, (3) external regulations and acceptable internal policies and procedures are followed, (4) satisfactory operating criteria are met, (5) resources are used efficiently and economically, and (6) the organisation's objectives are effectively achieved - all for the purpose of assisting members of the organisation in the effective discharge of their responsibilities."

These definitions highlight the importance of independence and objectivity as well as providing assurance and consulting services across the business environment. Assisting management and facilitating risk management processes and the achievement of objectives appear to be key to internal audit.

2.2 The history of auditing

A summary of internal audit's history should enhance understanding of the function. Modern internal auditing has its roots in external auditing. Evidence of auditing could be found as far back as 3500 B.C. Records of the Mesopotamian civilization show verification marks at the sides of numbers involved in financial transactions. Similar systems can be found in early Egyptian, Chinese, Persian and Hebrew records. Ancient Rome used a system of "hearing of accounts" which amounted to oral verification. Auditors were introduced to examine the accounts of provincial governors for the detection of fraud and the misuse of funds. Columbus was accompanied by an auditor, representing Queen Isabella, to the New World. The Industrial Revolution in England saw accountants being appointed to scrutinise written records and compare entries in the books of account with documentary evidence.

Internal audit had its birth in the United States where the economy escalated after World War 1. Railroad executives adopted a far-flung internal audit programme to provide assurance that stationmasters across the country were handling receipts properly. Official recognition of Internal Audit as a separate discipline was achieved by the founding of the Institute of Internal Auditors in 1941 in New York. (Sawyer, 1996:7, Barlow et al., 1995:19).

The natural progression of internal auditing can best be described as per table 2.1.

Table 2.1 Natural progression of internal auditing

History Of Auditing	Pro/ Reactive	Regarded Audit Universe	Progression - Handed over to Management based on:
1. Transaction Based	Proactive	All Financial Transactions	Checking function
2. Statistical Auditing	Reactive	Sample Financial Transactions	Supervisory function - partly handed over (Quality of Control Auditing)
3. Compliance	Reactive	All Financial Systems - but with	Management needs to ensure

Auditing		compliance focus	compliance (incl. Control Self Assessment)
4. Systems based	Proactive	All Financial Systems	Management reengineer and measure own systems (incl. Control Self Assessment)
5. Comprehensive Auditing	Proactive	All Control Systems - both design (adequacy) and effectiveness (compliance)	Management reengineer and measure own systems (incl. Control Self Assessment)
6. Risk Based	Proactive	All business risks that should lead to control (but in practice still with financial focus) - both design (adequacy) and effectiveness (compliance)	Management needs own Risk Management including Risk Assessment
7. Contextual Auditing	Proactive	All Objectives and strategies leading to risks	Current Internal Audit Focus with some parts of previous phases.

Source: Le Roux, 2000.

2.3 Components of a value adding internal audit function

A value adding internal audit function is required to support corporate governance for gaining a strategic advantage. It is thus necessary to examine the components of such a function. These components can be summarised as follows:

2.3.1 Independence

The internal auditor should be independent and objective to render impartial and unbiased judgements on activities audited. Work must be carried out freely and should not be interfered with. The internal auditor should not design systems or perform work on which he/she will perform an audit review later. Independence should be enhanced by internal audit reporting to an effective audit committee consisting of non-executive directors. (IIA, 1990 : 100, Barlow et al., 1995:11).

2.3.2 Status

Internal audit should have relevant status and standing in the company. This must be sufficient to ensure the accomplishment of audit's objectives and responsibilities. This could be achieved by reporting lines as per paragraph 2.3.1. and by means of a charter. The charter is like a constitution and forms a binding contract between the audit committee, senior management and internal audit. (IIA, 1990:110, Zhang, 1999:42).

2.3.3 Skills

Internal auditors should have the necessary skills, knowledge and discipline required to perform their functions. Internal audit should outsource the review of areas where they lack the technical skill to perform the work. Internal auditors must maintain their technical competency through continuous education. The Institute of Internal Audit South Africa developed a qualifications framework to facilitate properly skilled internal auditors. (IIA, 1990:210, Crosly, 2000:6, Barlow et al., 1995:12).

2.3.4 Professionalism

Professionalism is a key component of any internal audit function. Internal auditors must comply with the Standards and the Code of Ethics of the Institute of Internal Auditors. (IIA, 1990:240, Sawyer, 1996:25).

2.3.5 Audit methodology

Sound audit methodologies must be in place to ensure that internal auditors exercise due professional care in performing internal audits. A "one-size-fits-all" approach will not suffice in modern business. Rapid changes in technology requires audit methodologies to be reviewed and updated regularly to ensure success and the addressing of client needs. (Wagner, 2000:35).

2.3.6 Strategic direction

The internal audit function must be alligned with the organisation's strategic direction. Internal audits should not only address compliance in this area but should enhance the process. Internal audit must also provide consultation regarding the management of strategic risks. (Thevenin, 1997:58).

2.3.7 Risk management

Risk management must be the basis and driving force of the internal audit profession. Internal audit should be the change agents facilitating an enterprise-wide risk management approach. Risk management is management's business and internal audit supports management in the quest to achieve their objectives. (Wagner, 2000:35).

2.3.8 Assurance consultants

Internal audit must provide or facilitate assurance that business objectives will be met. The internal auditor should be an assurance consultant and be pro-actively assisting in the control design efforts as the traditional reporting on the mere existence of controls may have no bearing on whether objectives will be achieved. (McCraig, 1998:45).

2.3.9 Risk assurance partnering (other assurance providers)

Those accountable for end-result objectives should be trained in control concepts and control and risk design skills. The use of a broader range of assurance providers will ensure better and more cost effective control. (McCraig, 1998:45).

2.3.10 Performance measurement

Who audits the auditors? Internal audit clients must be appraised of the effectiveness, efficiency and quality of the function as reliance is placed on the assurance provided by them. Each function must define measurement and critical success factors to indicate the status of the function. (Ziegenfuss, 2000:38).

2.4 Internal audit value adding abilities

The value adding abilities of internal audit need to be studied as these abilities support corporate governance to gain strategic advantages. The relationships between the value adding abilities and corporate governance will be explored in chapter 4. The most significant value adding abilities are as follows:

2.4.1 Strengthen the internal control environment

Internal controls can be described as a management tool providing assurance that objectives are being met. Internal audit reviews and consults on internal controls. This brings skills and focus to bear on the internal control environment. A strong control environment provides assurance to all stakeholders that unexpected failures of organisations will be minimised and that objectives should be achieved. (Deloittes, 1996:2, Sawyer, 1996:85).

2.4.2 Assist management to identify and improve control weaknesses and performance problems

Internal audit reviews will identify control weaknesses and performance problems. Improvements developed in conjunction with management will enhance control and performance. The result is a higher level of assurance that objectives will be met. (Deloittes, 1996:2, Barlow et al., 1995:126).

2.4.3 Enhance the quality of the management process

Internal audit provides management with assurance or focuses their attention to specific areas of operation. Management may not always be able to determine the root cause of problems. Internal audit will identify the basic management principle violated, that will enhance the management process, should the corrective action be effective. (Deloittes, 1996:2, Sawyer, 1996:17).

2.4.4 Improve management's understanding of internal control and risk management

Internal audit consults on and educates management in internal control and risk management concepts. A study by the International Federation of Accountants suggests that organisations' economic performance will be enhanced by utilising the latest risk management tools and techniques. Internal audit, in partnership with management, could make a direct contribution to the bottom line. (Deloitte, 1996:2, Anon., 1999:13).

2.4.5 Enhance fraud prevention and detection

Internal audit contributes to the prevention of fraud by reviewing, recommending enhancements, and pro-actively consult on the design of internal controls. Although fraud detection is not a primary function of the modern internal auditor, approximately 10% of frauds are detected during audit reviews. A sound control environment detects the majority of frauds. (Deloitte, 1996:2).

2.4.6 Enable the demonstration of corporate governance compliance

The modern internal audit function supports compliance with corporate governance. The relationship between the value adding abilities of internal audit and corporate governance principles will be explored in chapter 4. (Deloitte, 1996:2).

2.5 Reasons for ineffective internal audit functions

These reasons were examined as they would confirm the accuracy of the components and value adding abilities identified in paragraphs 2.3. and 2.4. These pitfalls should be evaded to ensure a modern internal audit function.
A study by Ernst and Young (1998:10) highlighted the following findings regarding ineffective internal audit functions:

- internal audit functions are not involved in developing risk management strategies;
- internal audit functions do not have all the required skills to deal with specialist areas of the business;
- internal audit functions do not have access to leading edge audit methodologies;
- internal audit functions do not act as consultants providing risk management training to clients;
- the likelihood of fraud occurring does not reduce due to a lack of emphasis on risk management;
- internal audit functions, or parts of it, are not outsourced where a lack of skill and resources are evident.

This study supports the components and value adding abilities of the modern internal audit function as identified in paragraphs 2.3 and 2.4.

2.6 Conclusion

The literature study of internal audit highlighted the ten components required for a modern, value adding internal audit function. The study revealed the value adding abilities of internal audit and the relevance of these were tested by the study of the reasons for ineffective functions. It is now relevant to examine corporate governance to determine the components and strategic advantages before establishing the supporting role of a value adding internal audit function.

CHAPTER 3

CORPORATE GOVERNANCE

3.1 The definition of corporate governance

The King Committee (1994:1) defines corporate governance as: "simply the system by which companies are directed and controlled."

Monks et al., (1995:1) stated that: "Corporate governance refers to the relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) the shareholders, (2) the management (led by the chief executive officer), and (3) the board of directors."

3.2 The history of corporate governance

Although corporate governance is a fairly recent issue, there is nothing new about the concept. The concept has been in place as long as large-scale trade has been taking place. The new technologies of the Industrial Revolution demanded the creation of economies of scale. Increased capital requirements saw the birth of institutional investors. This resulted in owners (shareholders) not being able to personally manage companies any longer. They appointed professional managers to perform these functions. Over time some of these managers progressed to a higher level and boards of directors were established, corporate governance became critical to the proper functioning of this interdependence between shareholders, directors and managers. (King, 1994, Kendall and Kendall, 1998:15).

The most important developments in recent corporate governance are summarised below (Bentley, 1999:16).

3.2.1 United States of America

- **Foreign corrupt practices act – 1970**

This act followed Watergate in response to investigations by the Office of the Westgate Special Prosecutor and the Securities Exchange Commission.

- **Guidance of internal control – 1979**

Rules on Internal Control Reporting published by Securities Exchange Commission.

- **Treadway Commission – 1987**

The commission published Guidance on Internal Control. The report made 49 recommendations regarding the concerns on the extent to which intentional or reckless conduct, by act or omission, undermines the integrity of financial reporting and a re-examination of the extent to which it can be prevented, deterred or detected quickly. An important conclusion was that there was no agreed or accepted guidance on internal control.

- **Committee of sponsoring organisations (COSO) – 1992**

The committee published the report: “Internal Control - Integrated Framework”. The report provides a sound basis for establishing internal control systems and determining their effectiveness.

- **Blue Ribbon – 1996**

The National Association of Corporate Directors (NACD) released a report by their Blue Ribbon Commission on "Director Professionalism" focussing on the board's responsibilities and giving some guidance for evaluating the effectiveness of boards.

3.2.2 United Kingdom

- **Cadbury report – 1992**

The committee found that the failures of quoted companies have all been due to failures of internal control. The report and its Code of Best Practice required that the directors of a company should report on the effectiveness of the company's system of internal control.

- **Rutteman report – 1993**

Paul Rutteman published Internal Control and Financial Reporting: Guidance of Directors of Listed Companies registered in the UK.

- **Yellow book – 1994**

The Yellow Book combined the efforts up to 1994 and the London Stock Exchange (LSE) requirements. This stated that all listed companies had to include a statement on compliance with the requirements of Cadbury and/or reasons for non-compliance in their annual reports.

- **Greenbury report – 1995**

This report addressed directors' remuneration.

- **Hampel report – 1997**

The Hampel Committee reviewed the Cadbury Report and its implementation to ensure that the original purpose was being achieved. It also proposed certain amendments and deletions as considered necessary.

- **Combined code – 1998**

The Combined Code brought together principles of good governance and a Code of Best Practice based on Hampel, Cadbury and Greenbury.

- **Turnbull report – 1999**

The Turnbull Internal Control Working Party has recently published guidance for directors on the implementation of the internal control requirements of the Combined Code.

3.2.3 Canada

- **Criteria of control (Coco) – 1995**

The Canadian Institute of Chartered Accountants (CICA) published the report by their "Criteria of Control" (CoCo) Board in 1995 under the Chairmanship of Peter Jackson. This was published in two volumes: Control and Governance Number 1 - Guidance on Control and Control (Nov 1995) and Governance Number 2 - Guidance for Directors - Governance Processes for Control (Dec 1995).

3.2.4 Republic of South Africa

- **King Committee – 1994**

The King Committee was appointed by the Institute of Directors to make recommendations on the financial aspects of corporate governance. In addition, it was mandated to lay down guidelines for ethical business conduct and to address specific circumstances prevailing in South Africa such as the emergence of previously disadvantaged communities as a new class of entrepreneur into the business community.

The Committee comprised five task groups which addressed the following issues:

- Functions and responsibilities of executive and non-executive directors
- Role of external and internal auditors
- Nature and expectations of stakeholders
- Development of a code of ethics for business
- Compliance with the recommendations of the Report

- **King Committee II – 2001**

Corporate Governance in South Africa will be reviewed by the King Committee and the revised report is expected to be published during April 2001.

3.3 Corporate governance principles

The most significant corporate governance principles have been studied. These principles require focus as strategic advantages can be gained through successful achievement/compliance with corporate governance. This relationship will be expanded upon in chapter 4.

3.3.1 Accountability

Corporate governance focuses especially on director's accountability. This includes comments regarding their responsibility for preparing accounts, reporting on the effectiveness of the system of internal control and the monitoring of executive management activities. Further accountability and responsibility issues will be discussed under several of the headings below. (Kendall & Kendall, 1998:229, King 1994:5).

3.3.2 Communication

This principle has been termed communication rather than disclosure. Communication is believed to be more in the spirit of corporate governance as disclosure may become a "tick-box" approach. Communication should take place in a rather broad front including, inter alia, the aspects as per the other headings under paragraph 3.3, director's remuneration, appointment and retirement of directors, and other responsibilities of the board. The key is that all stakeholders are provided, in a transparent manner, with relevant information. (KPMG, 1998:2, CalPERS, 1999:1).

3.3.3 Structure

Corporate governance safeguards stakeholders against the directors abusing their powers. Structures providing for the chairperson and chief executive officer not being the same person, a sufficient number of well-equipped non-executive directors, skilled directors and an audit committee, facilitate this. (CalPERS, 1999:1, Deloitte, 1995:4)

3.3.4 Goals and strategy

A long-term vision is required to achieve a common goal. Essential to this statement is that directors must be aware of what shareholders expect. The directors are required to develop feasible strategies and put in place an appropriate organisation to achieve this goal. (Kendall & Kendall, 1998:157, CalPERS, 1999:1).

3.3.5 Control environment

The directors are ultimately responsible for the internal control system. Turnbull (1999:10) defines the aim of internal control as follows: "A company's system of internal control has as its principle aim the management of risks that are significant to the fulfillment of its business objectives with a view to safeguarding the company's assets and enhancing over time the value of shareholders' investment." The task of establishing, operating and monitoring the system will normally be delegated to management. The board however, retains the responsibility to assure that these processes are functioning effectively to monitor risk and to ensure that risk is reduced to an acceptable level. The board uses audit committees and management reports to obtain this information. It is recommended that the board utilises internal audit to evaluate risk and monitor the effectiveness of the internal control system. (Turnbull, 1999:29).

3.3.6 Risk management

This aspect link to internal control but is viewed as a significant principle and therefore documented separately. The board must ensure an ongoing process for identifying, evaluating and managing key risks. Focus of internal control is thus risk based. (Turnbull, 1999:33, Jones & Sutherland, 1999:6)

3.3.7 Ethics

An underlying ethical approach by all stakeholders in the business enhances operational economy, trust and loyalty beneficial to the health of the company over the long-term. As the essence of corporate governance is based on integrity, a partnership approach is required in all contractual relationships. (Kendall & Kendall, 1998:139, King, 1994:24). King (1994:25) recommends the development, publishing and enforcing of a code of ethics encouraging the above.

3.3.8 Affirmative action

This is an essential principle of corporate governance in the South African perspective. King (1994:24) recommends financially viable affirmative action programmes and warn against tokenism. This recommendation is significant as affirmative action is key to the survival and thriving of business within South Africa.

3.3.9 Environmental management

Although not widely accepted as a corporate governance principle in South Africa, this aspect rates highly internationally. King II will enlarge on this principle. (CalPERS, 1999:1, Vermeulen, 2000:2).

3.3.10 Worker participation

It is key to corporate governance to ensure that all employees have an appreciation of the subject and participate in the governance of the company. (KPMG, 1998:7).

3.4 Strategic advantages to be gained from corporate governance

"Strategy formulation is deciding where your organisation is today and where your organisation should be tomorrow. "(Kotze, 1998:1). A strategic advantage is viewed as where and how the organisation should move to in the future to set it apart from its competitors. In a corporate governance context, those aspects that would set the organisation apart or above its competition will be examined.

A literature study on this subject did not reveal much. Several benefits of corporate governance have been explored, but as these are implied in the summary of corporate governance principles as per paragraph 3.3., require no further attention for the purposes of this dissertation. Strategic advantages to be gained form corporate governance received significant attention during the structured interview process and will be expanded on in chapter 4.

The following corporate governance strategic advantages are summarised below based on a literature study.

3.4.1 Enhanced shareholder value

A study by McKinsey & Company found that investors will pay a premium for shares of companies with good corporate governance. High corporate governance can capture this governance premium available in the market creating significant shareholder value. (McKinsey & Company, 2000).

Investors gain can be attracted and retained in globalised capital markets through high governance standards. This lure of money will beneficiate shareholder value (Gill, 2000:1).

CalPERS found that an increased focus of management on corporate governance and performance issues result in increased returns on investment (CalPERS, 1996).

Good corporate governance will thus enhance economic performance and attract investment to create shareholder wealth.

3.4.2 Enhanced stakeholder assurance

High governance standards provides assurance to all stakeholders. The result is that the organisation is viewed as an admired company and a partner of choice (Kendall & Kendall, 1998 : 139).

3.5 Reasons for corporate governance failure

These reasons were examined as they would have to be addressed to ensure the gaining of a strategic advantage. A study by KPMG (1998) revealed that no South African company comply in full with the recommendations of the King Committee on corporate governance. The following reasons have been documented as the major causes for non-compliance or corporate governance failure.

3.5.1 Lack of skilled directors

It is becoming evident that a large number of directors do not have the necessary skills to perform their duties. A lack of understanding of corporate governance and its strategic advantages result in a tick-box approach rather than an embracement of the spirit of corporate governance (Gill, 2000:2).

3.5.2 Re-structuring

Many organisations decide not to introduce corporate governance as they are in a process of re-structuring. Again there is a lack of understanding as corporate governance is essential during this process. (Gill, 2000:2).

3.5.3 Not in touch with investor attitude

Organisations, especially in South Africa, have not yet realised that investors demand good governance. International investors are willing to pay a premium for shares of companies with high governance and this attitude is moving to South Africa. Investors will, increasingly, severely penalise poor governance. (Gill, 2000:2).

3.5.4 Lack of legal backing

Corporate governance in South Africa is based on the recommendations of the King Committee. Affected corporations are not compelled to implement these recommendations. These recommendations will be enforced should they receive legal backing in, for example, the Companies Act, Johannesburg Stock Exchange Regulations, etcetera. The United Kingdom took a leading step in this regard to great effect. (Sikhakhane, 2000:1).

3.5.5 Lack of transparency

Several companies have not yet discovered the power of transparency. They disclose the minimum information as per King's recommendations and ignore some of these, especially regarding directors' remuneration. They have yet to notice that this leads to suspicion and distrust by stakeholders. (Anon. 2000:5).

3.5.6 Structural deficiencies

It is still too often found that the chairman and chief executive is the same person. This situation coupled with an insufficient number of skilled non-executive directors and an absent or inefficient audit committee completes the recipe for abuse of power by executive directors. (Anon., 2000:5).

3.5.7 Lack of shareholder activism

There is a lack of shareholder activism in South Africa compared with other countries. Shareholders exercising their ownership interests force high corporate governance standards. (Anon., 2000:5).

3.5.8 Lack of guidance

The King report lacks in guidance for the implementation of corporate governance. This has been recognised in, especially the United Kingdom, who introduced guidance for the implementation of the Combined Code to great effect. (Anon., 2000:5).

3.6 Conclusion

The literature study of corporate governance revealed ten significant components as well as the strategic advantages to be derived from good governance. Structured interviews will be conducted to determine further perspectives and the supporting relevance of a value adding internal audit function.

CHAPTER 4

FURTHER PERSPECTIVES AND THE RELATIONSHIPS

4.1 Introduction

This chapter encompasses the results of structured interviews to confirm the results of the literature study, to fill several literature gaps and establish the relationships between the components of a value adding internal audit function, value adding abilities of internal audit, principles of corporate governance and the strategic advantages to be gained from corporate governance. Ten structured interviews were conducted as the required level of perspective should be obtained by in-depth interviews with experts in this field of study. The interviewees are all experts in their respective fields. The interviewees included four experienced practicing internal auditors as the study focused on internal audit's supportive role to corporate governance. As corporate governance is key to modern internal audit, these individuals have been able to contribute, not only to the internal audit aspects, but also to those relating to corporate governance and more importantly the relationships between internal audit and corporate governance. Two audit committee chairpersons have been interviewed for their contribution regarding corporate governance and their contributions regarding internal audit based on what they require from internal audit. Two professional consultants on internal audit and corporate governance have been interviewed to obtain their professional input and perspectives gained from a wide spectrum. One of these individuals is also an audit committee chairperson. Two investment analysts have been interviewed to obtain their perspectives regarding the strategic advantages to be gained from corporate governance. A copy of the structured interview framework is attached as Annexure A.

4.2 Components of a value adding internal audit function

The literature study revealed no comprehensive list of the components of a value adding internal audit function. The components, based on those aspects receiving most attention in literature, had to be confirmed. The structured interviews were aimed at highlighting any additional components and to gain further perspective on those selected following the literature study.

All interviewees agreed with the selection of the ten most significant components of a value adding internal audit function. Several additional "components" were raised, but after discussion it became clear that, although worth mentioning, these are subsets or supportive to the ten components listed. The following paragraphs contain summaries of their views.

The unanimous view is that independence is the most critical component. Independence could be further enhanced by the board being responsible for the appointment and removal of the director of internal audit. It is also key that internal auditors should not subordinate their judgements on audit matters to that of others.

Credibility is an issue that requires further evaluation. Credibility is a critical output of the components and essential to a value adding function. As internal audit is a function supportive to management by providing management and the board with assurance, it needs credibility as a partner in this relationship.

The literature study on skills concentrated on the hard technical skills as part of every internal auditor's toolkit. The modern internal auditor, however, requires well-developed soft skills as part of his/her armament. The most important of these skills appear to be communication and relationship building skills. Communication skills enhance both credibility and relationships. The internal auditor will have a much-improved chance of achieving his/her objectives if the internal audit process and the results thereof, are communicated in an effective manner. Successful relationship building has two pillars, being win-win and mutually pleasant. A win-win relationship requires the sharing and achievement of a common purpose between internal audit and its clients. A mutually pleasant relationship is built on the foundations of good manners and mutual respect and trust. An internal audit function needs to be structured so as to optimise skills and ensure the deployment of adequate skills in relevant areas.

Technology was another issue that required further examination. Technology is viewed as an integral part of the audit methodology. A modern audit methodology would demand the use of technology and would dictate the type of technology to be used. Computerised tools are increasingly used to support audit methodologies.

Examination of the assurance consultants component revealed that, although management is responsible for the control environment, they require a support base providing structure and resource to assist them with the effective discharge of their responsibilities. Internal audit, as assurance consultants, fulfill this role.

Performance measurement has a perspective other than only appraising the internal audit function. It is felt that, as internal audit is supportive to management by assisting them with the achievement of their objectives, a measurement of management's performance will indicate the degree of internal audit's success.

The results of the literature study and structured interviews provide credibility to the ten most significant components of a value adding internal audit function and indicated that all ten are essential building blocks to finally achieve a strategic advantage.

4.3 Internal audit value adding abilities

Only one source listing the value adding abilities of internal audit was found during the literature study. The interview process attempted to reveal additional value adding abilities of internal audit and also to test the internal audit literature study by evaluating the reasons for ineffective internal audit functions.

The value-adding abilities of internal audit were measured in terms of the Committee of Sponsoring Organisations (COSO) framework. The five essential components in terms of COSO are:

- the control environment
- risk assessment
- control activities
- information and communication, and
- monitoring.

This evaluation confirmed the value adding abilities of internal audit as per paragraph 2.4. but suggested that monitoring is a value adding ability underlying each of these abilities. Internal audit adds value to the board by assisting in their monitoring responsibility. This process provides credibility to the board's communication with stakeholders. All of these value-adding abilities are required as the next set of building blocks to achieve a strategic advantage.

4.4 Corporate governance principles

The literature study revealed no attempts at listing the most significant corporate governance principles. The principles were compiled taking note of those receiving most attention in literature. The structured interview process aimed to confirm these principles, highlight any additional principles and test the study by evaluating the reasons for corporate governance failures.

The structured interviews confirmed the list of the ten most significant corporate governance principles. It is evident that accountability is viewed as the most important principle threading through corporate governance. No further contributions were made.

Further evidence was obtained that these principles are essential to achieve strategic advantages as the list compared favourably with the criteria used by Deloitte & Touche to determine the winner of the annual corporate governance award. An examination of this criteria reflected the importance of a qualitative compliance with corporate governance, embracing the spirit of governance versus a quantitative “we do it” approach.

The reasons for corporate governance failures were discussed as these were viewed to provide further credibility to the list of most significant corporate governance principles.

The interviewees offered the following perspectives regarding the lack of legal backing and a lack of transparency.

Interviewees were divided on the issue on whether corporate governance should be granted legal backing, or not. The behavioural theory was used as the basis for these arguments. Four of the interviewees are in favour of legislating corporate governance to force appropriate behaviour that should result in the desired attitude of embracing the spirit of corporate governance as the benefits and strategic advantages materialise. The other six promote a change in attitude that should result in good corporate governance behaviour. The conclusion was that both concepts would be successful. The lack of transparency in South African corporate governance is believed to be a legacy of the sanction-busting era. This mindset of secretive action and a lack of disclosure is still embedded in todays boards and management and should diminish over time.

These corporate governance principles are the last building blocks required to achieve a strategic advantage.

4.5 Strategic advantages to be gained from corporate governance

The strategic advantages to be gained from good corporate governance as highlighted by the literature study were tested through the interview process. The aim was to obtain further perspective on the strategic advantages to be gained from corporate governance and, especially, on how the South African investor evaluates corporate governance in making an investment decision.

4.5.1 The South African investor

Interviewing of investment analysts revealed that corporate governance does not receive significant attention in South Africa, yet. This is in contrast with international investors, like CalPERS, that has gone as far as developing measurement criteria for corporate governance that significantly influence investment decisions. Local investment analysts, however, merely form a general view on the standard of corporate governance in a company. A positive finding is expected and receives no "marking up" of the share. A negative finding, however, is penalised and the investment opportunity is severely marked down. This situation is anticipated to change as South African investors increase their international investments and as international investment institutions contribute to the creation of shareholder activism in South Africa.

4.5.2 The advantages

The interviewees agreed to the strategic advantages of enhanced shareholder value and stakeholder assurance, as identified by the literature study. No significant other advantage was offered, but the two listed advantages were further explored.

Enhanced shareholder value discussions revealed no significant additions to the information gained through the literature study. A review of various generic strategies, such as competitive strategies like low-cost provider, differentiation and best-cost integration strategies, offensive strategies and defensive strategies revealed that corporate governance will be supportive to all of these to enhance shareholder value. It was concluded that all ten corporate governance principles would be supportive to each strategy and, because of the focus brought about by corporate governance, will provide a strategic advantage over those competitors with poor governance.

A review of enhanced stakeholder assurance resulted in the examination of the most significant corporate governance stakeholders. This examination revealed the strategic advantage in having good relationships with all stakeholders such as shareholders, employees, bankers, suppliers, customers, environmentalists, the community and the state. The view is that all ten corporate governance principles will support this relationship to provide a strategic advantage over those competitors with poor governance. The most significant finding was that high governance provides credibility, which is a critical relationship-building element.

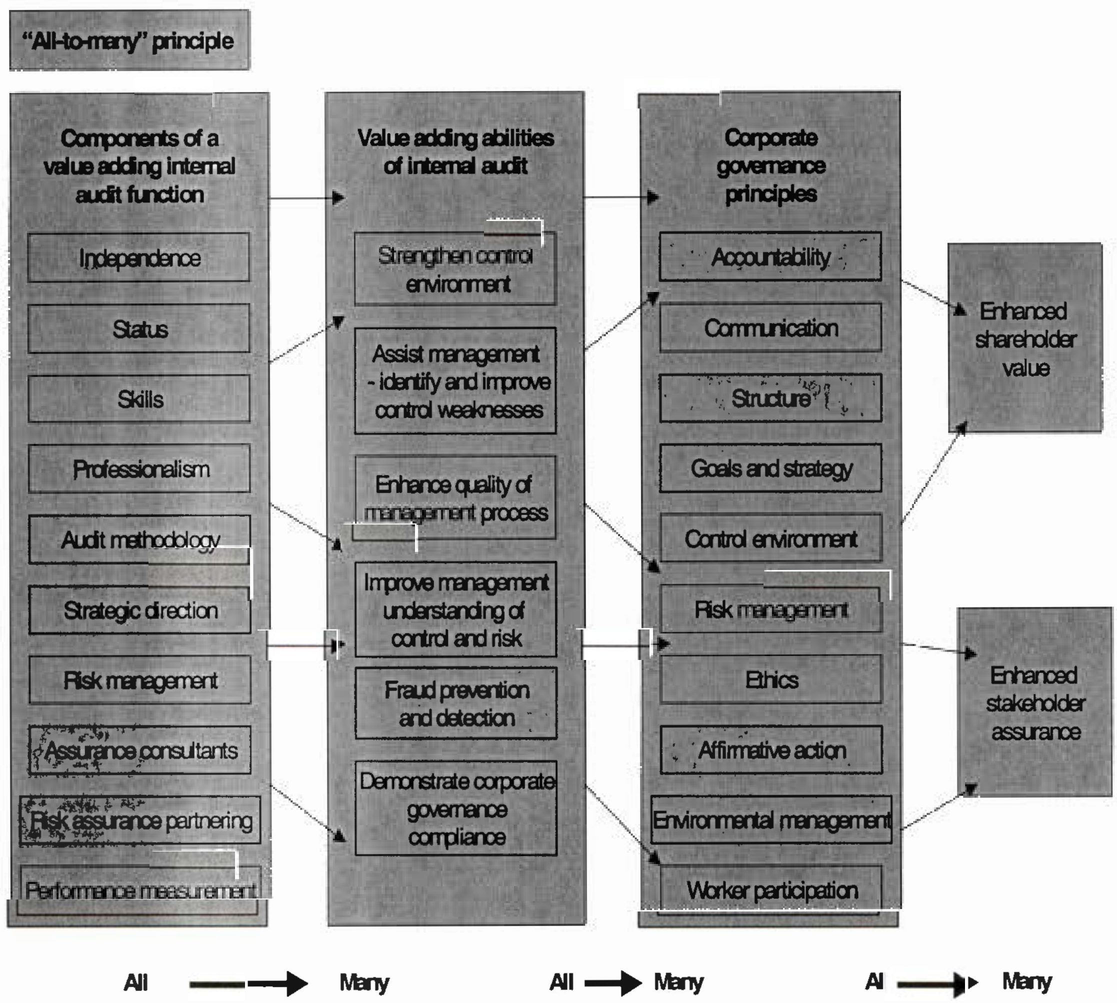
4.6 Relationships

The structured interview framework concluded with gaining input from interviewees to determine the relationships between the components of a value adding internal audit function, the value adding abilities of internal audit, the principles of corporate governance and the strategic advantages to be gained from corporate governance.

The most significant contribution of this study was the realisation of the principle : "All-to-many". The "All-to-many" principle revealed that all ten components of a value adding internal audit function are required to support many of the value adding abilities of internal audit. If one of these components is missing the value adding ability of internal audit will be ineffective. The same "All-to-many" principle is true in the relationships between the value adding abilities of internal audit supporting the ten most significant corporate governance principles and these principles gaining strategic advantages.

Figure 4.1 provides a schematic display of the "All-to-many" principle.

Figure 4.1 The "All-to-many" principle



Source: Self-developed

4.7 Conclusion

The literature studies and the structured interviews provided the information and knowledge required to now develop an integrated model of a value adding internal audit function supportive to corporate governance for gaining a strategic advantage.

CHAPTER 5

A MODEL FOR INTEGRATING INTERNAL AUDIT AND CORPORATE GOVERNANCE FOR GAINING A STRATEGIC ADVANTAGE

5.1 Introduction

A model, integrating internal audit and corporate governance, for gaining a strategic advantage, was developed based on the literature study and information gained during the structured interviews. See figure 5.1.

5.2. The model – a perspective

The various elements of the model will be discussed to provide the reader with a better perspective and understanding.

5.2.1 Corporate governance framework

The model reflects all processes, including internal audit, operating within the corporate governance framework. The process is integrated as corporate governance provides a framework for credibility to the processes and the processes demonstrate the spirit of corporate governance. The strategic advantages, as discussed in chapters 3 and 4, are the result of these interactive processes. The corporate governance framework reflects the definition of corporate governance (simply the system by which companies are directed and controlled) more than adequately. It is essential that all the corporate governance principles are embraced. Failing to embrace any of the principles will taint credibility and result in failure of the framework.

The various processes are also of cardinal importance. If you cover any one of the processes, and the remainder will reflect an ineffective framework that can only fail.

5.2.2 The board

The board of directors is ultimately responsible for corporate governance, hence placing them at the top of the processes within the framework. A given of the "board rectangle" is that the board will be constituted as dictated by corporate governance. This includes that the chairman and chief executive officer will not be the same person and that the chairman is a non-executive member of the board. The board will have a balance between skilled executive and truly non-executive members. Various committees such as an audit committee, remuneration committee, etcetera, would have been formed, comprising of non-executive members.

A further reason for placing the board at the top is to demonstrate their accountability for the total process. Although they delegate the responsibility for various activities, they retain accountability. The board is responsible for setting strategic direction. They need to ensure that this direction is aligned with shareholder vision. They are also responsible for the risk management process. The framework reflects the delegation of the management process, day-to-day risk management and the establishment and maintenance of the internal control environment to management.

Monitoring is evident in the framework. The board retains its finger on the pulse by requiring feedback on the progress and status of the delegated responsilbilities. Included in the above, are the key corporate governance principles of affirmative action, environmental management and worker participation. The golden thread, integrated throughout these processes, is ethics. The flow diagram indicates closure of the loop with reporting back to the board. The processes, within the corporate governance framework, with its resultant credibility, enable the board to communicate in a transparent manner with all stakeholders. This is normally done through the annual report, which should contain a directors statement on corporate governance. This communication should demonstrate the embracement of the spirit of corporate governance.

5.2.3 Management

Management receives the strategic direction and plans from the board. The dotted line indicates their relationship with the board and encompasses the delegation of responsibility by the board to the team of professional managers. The dotted lines to the strategic plan and risk assessment indicate management's participation in these processes.

Management accepts these responsibilities which give rise to the management process, the detail of which is viewed outside the scope of this dissertation. Management sets functional strategies and objectives and develops operational plans to achieve the strategic plan. Management is responsible for managing the risks identified and develops appropriate risk management strategies. The most important of these is the establishment and maintenance of an internal control environment. Management develops reports and other mechanisms to self-assess the effectiveness of the control environment and risk management and the achievement of functional strategies and objectives. The management process includes addressing control weaknesses and performance problems.

Management provides regular feedback to the audit committee and the board on the effectiveness of the control environment and risk management, as well as the achievement of functional strategies and objectives. This gives rise to an "agency" type problem that will be discussed in more detail in paragraph 5.2.4.

5.2.4 Internal audit

All the components of a value adding internal audit function are required to unleash the potential and value add of a modern internal audit function. Similar to corporate governance principles, failure to embrace any one of these components will result in an ineffective or failing function.

The internal audit function has been enclosed in a rectangle with the heading "Recommendation". This has been done as most corporate governance reports "recommend" that organisations should establish and support internal audit functions. The Turnbull Committee contains a statement stronger than most, by demanding that organisations without internal audit functions disclose the reasons for not having an internal audit function and that the situation be reviewed, at least annually. The support to, and integration with, corporate governance and its board and management processes, can best be demonstrated by blanking out the internal audit process from the model. The remainder reveals an incomplete and much weakened process.

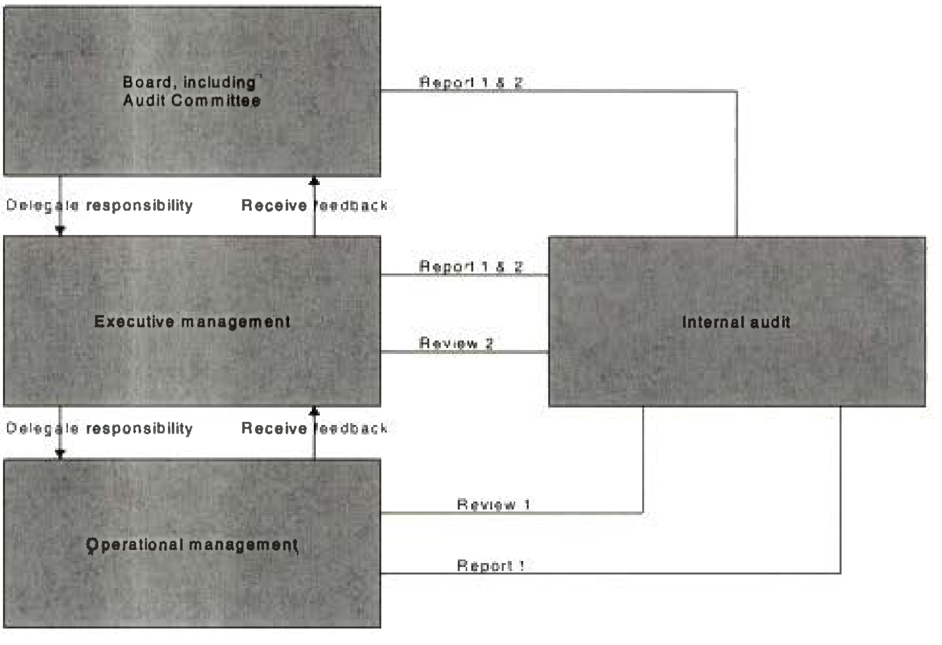
The dotted lines from internal audit to the board and from the internal audit processes to management reflects the assistance of internal audit to the board and management to achieve their objectives The dotted line to the strategic direction block reflects internal audit's alignment with the goals and strategic direction of the organisation. The dotted line to risk management indicates internal audit's assistance in respect of the process and their responsibility for enhancing management's awareness and understanding of the subject.

The flow diagram indicates that risk management is the starting point of the audit process, hence the term risk-based auditing. Assurance plans, designed to provide management and the board with an independent appraisal of the effectiveness of risk management, are developed from the risk assessment. These assurance plans include the reliance on, and co-ordination of, assurance provided by others, hence the term risk assurance partnering. Audit plans, on which audit activities are based, are developed from the assurance plans, reflecting details of the service to be provided by internal audit. These would demonstrate the value adding abilities of internal audit as described in chapters 2 and 4. The dotted lines to management do not only indicate the assistance to management, but also management's participation in developing the plans and scoping the service. This interaction ensures that the client's needs are being addressed and enhances the relationship as a common goal is established.

The internal audit activities directed to the management and risk management processes will include reviews of the effectiveness and efficiency of these processes. Internal audit assists in the achievement of objectives and enhances the effectiveness of the management process. Internal audit will consult on risk management and enhance management's understanding of the process. The control environment is reviewed for effectiveness and efficiency and management is assisted by obtaining an objective view on the status of the control environment. Internal audit consulting will enhance the control environment and management will be assisted to develop corrective action regarding control weaknesses. Internal audit's contribution as per the above will contribute to the prevention and detection of fraud.

Internal audit will review and report on the self-assessment process performed by management. Objective and independent reporting of audit findings to management and the board alleviates the "agency" problem. This problem can best be described by the following diagram.

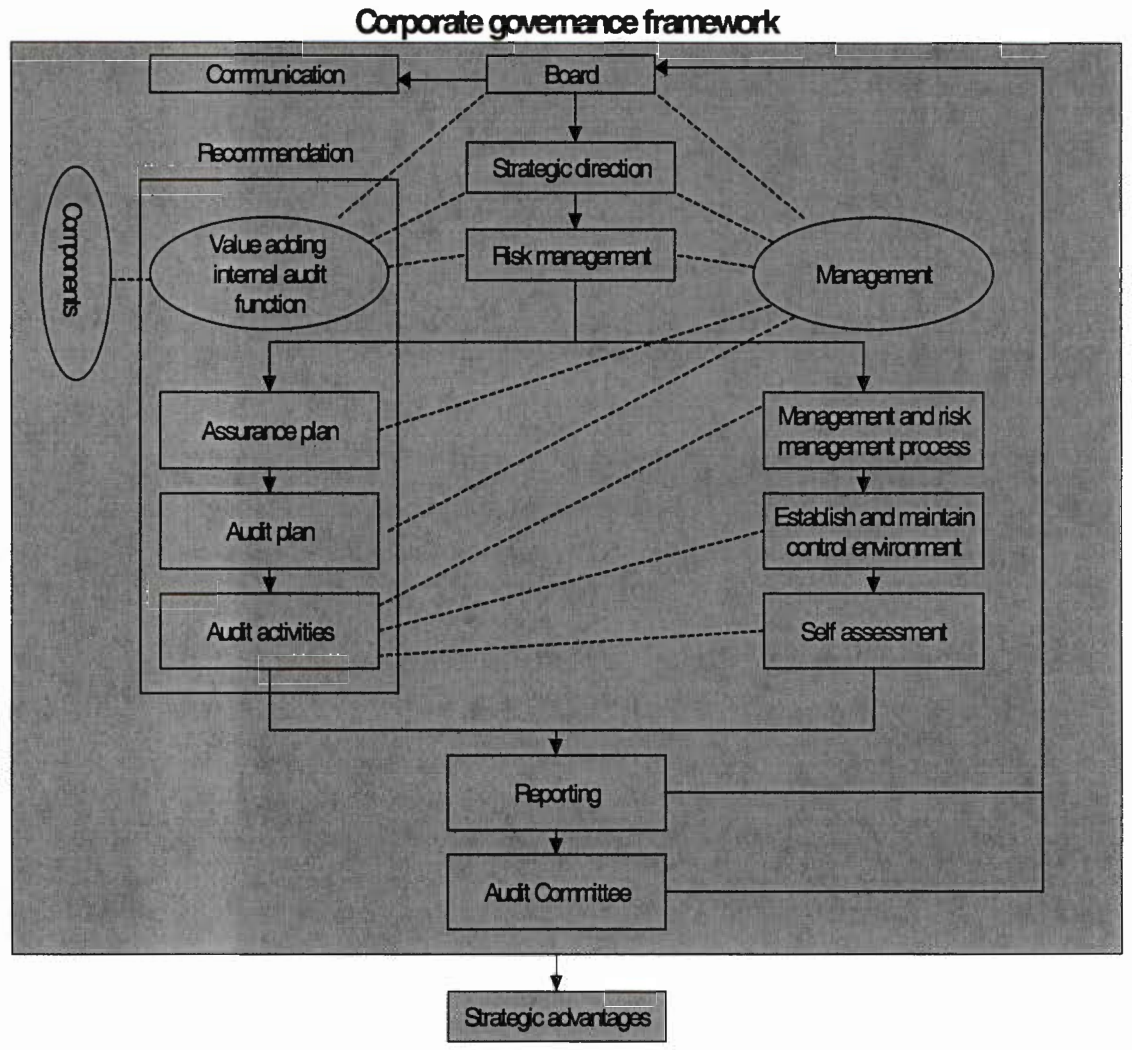
Figure 5.2 The agency problem



Source: Adjusted (Le Roux, 2000)

The board delegates responsibility to executive management that includes, inter alia, achievement of objectives, risk management and the establishment and maintenance of the internal control environment. The board requires feedback from executive management on the achievement and performance regarding delegated responsibilities. The same process takes place between executive and operations management. The “agency” problem arises as the feedback process from operations to executive, and executive management to the board may be biased (“tell them what they want to hear”). Reviews by internal audit and reporting on the results provide independent feedback and thus credibility to management feedback.

Figure 5.1 The model



Source: Self-developed

5.3 CONCLUSION

The study highlighted the most significant components of a value adding internal audit function, the value adding abilities of a modern internal audit function, the most significant corporate governance principles and the strategic advantages to be gained from corporate governance. The "all-to-many" principle indicates that all of the above must be embraced. Failing to embrace any one of the aspects ("all") will result in failures in the next process ("many"). The model indicates the integration of the processes, as well as the key inter-dependencies. These processes take place within, and are integrated with, the corporate governance framework gaining strategic advantages.

Companies need to embrace the spirit of value adding internal audit functions supportive to corporate governance to gain strategic advantages.

Further study should be undertaken to establish the relationship between enhanced value adding internal audit functions and corporate governance and the resultant growth in shareholder value and shareholder assurance.

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