

# The perceived effectiveness of audit committees in the South African public service

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## Abstract

Audit committees have increasingly been recognised as an integral part of modern control structures and governance practices in both the private sector and public service. The audit committee is an integral element of public accountability and governance processes. It plays a key role in underwriting the integrity of corporate governance of a government department.

The broad aim of this study is to investigate the status and function of audit committees in South African national government departments. The research question investigated in this paper is to determine whether audit committees in the public service are perceived to be effective in assisting accounting officers of government departments to discharge their responsibilities. The study concludes that the majority of audit committees in the South African public service are not perceived as ineffective in the performance of the required functions of committees. Audit committees can still improve their effectiveness in their performance of certain key functions in the areas of oversight over risk management, governance, financial reporting, internal control and support for the external audit function.

## Key words

*Audit committees*  
*Audit committee regulation*  
*Audit committee responsibilities*  
*Effectiveness*  
*External audit*  
*Financial reporting*  
*Internal audit activity*  
*Risk management*

## 1 Introduction

The audit committee is a key accountability instrument that plays a critical role in the financial management and control environments of public entities (Bedard, Gendron & Gosselin 2004:153). Audit committees are increasingly regarded as an integral part of modern control structures and governance practices in both the private sector and public

service. Public service legislation in South Africa requires that, in addition to it establishing effective controls and governance practices to have an audit committee, it is now a legal requirement to have such a committee for each government department or public entity (South Africa 1999:s. 77).

The audit committee forms part of the accountability structures created in the public service and assists heads of department or entities in demonstrating the accountability expected of them and in discharging the responsibility placed upon them by the Public Finance Management Act 1 of 1999 as amended). This study measures the perceived effectiveness of the audit committees of national government departments in South Africa.

## **2 Research problem and methodology**

The establishment of an audit committee is widely recognised as a best practice in good governance, and has therefore been included in public service financial management legislation in South Africa (South Africa 1999:s. 77). Conceptually, the need for audit committees can be traced back to the reasons for maintaining the independence of the audit function, which later came to include the internal audit activity (Cory 1988:1). Although many audit committees exist today, the degree to which they are effective varies (Jack 1993). This also applies in the public service.

As the broad aim of this study, audit committee effectiveness was investigated in terms of the generally recognised functions of such committees. The research will attempt to find an answer to the question whether public service audit committees are perceived to be effective in their contribution to good governance. The research is an extension of previous research that measured the internal audit activity's perception of audit committee effectiveness. The earlier research has been extended to measure the perceived effectiveness of audit committees in the public service from the perspective of accounting officers, chief audit executives, chief financial officers, audit committee chairpersons and external audit.

The research question of this study can be formulated as follows:

*Are audit committees in the South African public service perceived to be effective in their contribution to good governance?*

For the purpose of the research, semi-structured interviews were conducted with the accounting officers, chief financial officers and audit committee chairpersons of selected national government departments (one department from each of the five functionary clusters in government). Semi-structured interviews were also conducted with a selection of senior staff members of the Auditor-General. The purpose of the interviews was to give the researcher an idea of these officials' experiences, perceptions and perspective on the functioning of audit committees. In addition to the interviews, data were obtained from chief audit executives by means of a questionnaire.

During interviews with staff of the Auditor-General, and audit committee chairpersons, the interviewees were requested to do an effectiveness rating of the key responsibility areas of an audit committee on a Likert-type scale from one to five. Chief audit executives did a similar rating on the questionnaires. These ratings were then converted into percentages to obtain a quantitative assessment of the perceived effectiveness of audit committees. Questions that allowed for open-ended answers were included, to obtain information on the shortcomings in and suggested improvements to the functioning of audit committees.

### 3 Audit committee functions

“The most effective audit committees are not only critically aware of their responsibilities but also completely understand and embrace them, and recognise what is necessary to fulfil them effectively” (KPMG 2006a:12). The work of the audit committee has evolved in response to changes in the international business environment, legislative requirements as well as increased accountability to regulators and investors (Gaynor, McDaniel & Neal 2006:874). The American Bar Association (Brewer 2001:28) indicated the functions of the audit committee, and those that can be applied to the public service as follows:

- Review the external auditor’s compensation, terms of engagement and independence.
- Review the appointment and replacement of the chief audit executive.
- Serve as a channel of communication between the board and both external and internal auditing.
- Review the results of the external audit, management letters and management’s responses. The committee must also review reports from the internal audit activity that are material to the corporation as well as management’s response to these reports.
- Review the annual financial statements and any significant disputes between management and the external auditor in this regard.
- Consider, in consultation with the external auditor and the chief audit executive, the adequacy of the organisation’s system of internal control.
- Consider major changes and other major questions of choice regarding the appropriate auditing and accounting principles and practices to be followed when preparing the department’s financial statements.
- Meet periodically with management to review the department’s major risk exposures.

In a more recent description of the functions of the audit committee, Braiotta (2004) divides the functions of an audit committee into three distinct categories, namely planning, monitoring and reporting. This implies that the audit committee must plan its activities to provide assurance to the accounting officer that the accounting and auditing functions are providing the required assurance. The audit committee reports to the accounting officer as well as to Parliament through a report in the annual report of a department (South Africa 2005:ch. 3).

KPMG (2006a:12) classifies the responsibilities of the audit committee under three key areas of responsibility as reflected in table 1 below:

**Table 1 Key audit committee responsibilities**

Assessing the risk and control environment	Overseeing financial reporting	Evaluating the audit process
Control Environment	Earnings Releases	Internal Audit Mission
Risk Assessment	Financial Reports	Independent Audit Expectations
Control Activities	Committee Diligence	Collaboration & Communication
Information & Communication	Committee Assessment	Understanding Results & Conclusions

Source: KPMG (2006a:12)

The key areas identified in table 1 above are elucidated below.

### **3.1 Assessing the risk and control environment**

Risk management is a management responsibility to assess the potential impact of negative events on the organisation (King Report 2002). According to Walker (2004:181), recent guidelines suggest that it is the audit committees that should oversee the assessment of risks facing the organisation. Because this is still the responsibility of management and the board, Walker (2004) indicates that audit committees should confine their involvement in risk assessment to a forum in which risks are assessed. Keinath and Walo (2004:24) state that risk assessment and risk management have been of particular concern since the Enron scandal – hence the need for audit committees to understand the business and be aware of the financial risks that could be threats to their companies.

PWC (2006:18) suggests the audit committee should take the following steps to oversee risk management as depicted in table 2 below:

**Table 2 Steps to oversee risk management**

Know the extent to which management has established effective enterprise-wide risk management.
Be aware of and concur with the company's risk appetite.
Inquire as to who is responsible for risk identification, assessment and management throughout the company, and to meet periodically with these individuals.
Discuss with management its processes to identify events that put the company at risk, including fraud risk, and how management assesses the likelihood and impact of identified risks.
Understand the internal audit activity's role and planned coverage, and meet periodically with the chief audit executive.
Review financial reporting risks and consider the level of risk against the company's risk appetite.
Discuss with management the controls that are in place to mitigate key financial reporting risks and how effective the controls are.

Source: PWC (2006:18)

The above information emphasises the importance of the audit committee monitoring the risk management processes in an organisation. It also indicates the level of expertise that is required of members of audit committees to be able to perform this function.

### **3.2 Overseeing financial reporting**

The audit committee's responsibilities include assisting management in the discharge of their responsibilities by overseeing the financial reporting processes, to ensure that it provides accurate and useful information to users. The King II Report (2002) states that the audit committee must assist the board (management, in the public service context) to discharge their duties in the preparation of accurate financial statements in compliance with all applicable regulations, legislation and accounting standards. The report also states that the audit committee must examine and review the financial statements and accompanying reports. It must also review the full annual report of the organisation to ensure that it presents a balanced assessment of the organisation's position, performance and prospects.

According to KPMG (2006a:16), the audit committee should assume the following responsibilities in financial reporting in an entity, as identified in table 3.

**Table 3: Responsibilities in the overview of financial reporting**

Understand management's responsibilities and representations.
Understand and assess the appropriateness of management's selection of accounting principles and of the most critical accounting policies.
Understand management's judgements and accounting estimates as applied in financial reporting.
Understand the communications received from the external auditors concerning their responsibilities under generally accepted audit standards.
Confer with both management and the external auditors about the financial statements.
Assess whether financial statements are complete and fairly represent, in all material respects, the financial position of the company and that disclosures are clear and transparent.
Review earnings releases, financial statements, and other information presented with the financial statements, prior to release.

Source: KPMG (2006a:16)

The information presented above emphasises management's responsibility to prepare complete and accurate financial statements and disclosures. The audit committee must obtain assurance from the external auditors that they are satisfied that the accounting estimates and judgements made by management reflect the correct application of the relevant accounting standards.

### 3.3 Evaluating the audit process

A key responsibility of the audit committee is to evaluate the audit process in the organisation. The process followed by both external and internal auditing must be evaluated for effectiveness and value added.

#### 3.3.1 External audit

The responsibilities of the audit committee extend to both the internal and the external auditing of the organisation. In terms of the previous section, the audit committee must be assured that the financial reporting process and the system of internal control in the organisation comply with acceptable standards. Regarding their relationship with the external auditors, Braiotta (2004:83) states that both the audit committee and external audit have a common objective for the financial affairs of the organisation. The audit committee must review the external audit plan and receive the resulting report and recommendations from the external audit (Gazzaway 2008:23). In addition, Gazzaway (2008:22) indicates that the audit committee must be comfortable that the auditors have the required skills to address key areas of financial reporting risks. PWC (2006:47) states that external audit should report directly to the audit committee, and not through management.

#### 3.3.2 Internal audit

The internal audit activity in the organisation will be evaluated in terms of the following elements:

#### **Independence and reporting**

In terms of the audit committee's relationship with the internal audit activity, Meyers and Ziegenfuss (2006:53) emphasise the importance of the audit committee having an open line of communication with the chief audit executive. The audit committee should meet with the chief audit executive on a quarterly basis. Topics that should be discussed include internal

audit activity engagements, control environment matters and internal auditing results (KPMG 2006b:4). The audit committee must satisfy itself that the reporting structure of the internal audit activity reflects its organisational independence and objectivity (PWC 2006:37). The key to this requirement is that the chief audit executive reports administratively to the accounting officer (head of department) and functionally to the audit committee. This implies that the audit committee will receive the reports from the internal audit activity and review management's proposed actions and monitor the progress in respect of the audit findings. The audit committee must ensure that management have implemented the important recommendations received from the internal audit activity (CIPFA 2005:32). After follow-up audits, cases in which recommendations have not been implemented should be reported to the audit committee (CIPFA 2005:32).

#### **Internal audit charter, resources and coverage plans**

The internal audit charter forms the basis of the independence, engagements and communication lines of the internal audit activity (IIA 2007:20). Practice advisory 1000-1 prescribes that the chief audit executive is responsible for obtaining an approved written charter for the internal audit activity. This charter, which should be agreed upon by management and approved by the audit committee, spells out the purpose, authority and responsibility of the internal audit activity (IIA 2007:20).

One of the requirements in the South African public service is that the internal audit activity should develop a three-year rolling strategic plan based on the risk matrix of the department (South Africa 2005:ch. 3). It is the audit committee's responsibility to approve the internal audit plan and to monitor performance against this plan (National Treasury 2001:13). The audit committee should require quarterly feedback from the chief audit executive on the progress made in implementing the approved plan, and request an explanation of the reasons for any deviations from this plan.

## **4 Audit committee effectiveness**

Cohen, Krishnamoorthy and Wright (2002:56) define an effective audit committee as one that is independent of management's influence and one that understands the financial reporting process. It is stated that an audit committee must comply with regulations, but they do not provide active oversight over the financial reporting process. De Zoort, Hermanson and Reed (2002:40) identify the following four determinants of audit committee effectiveness:

- 1 *composition*: expertise, independence, integrity and objectivity
- 2 *authority*: responsibilities and influence on management and auditors
- 3 *resources*: adequate number of members; access to management, external auditors and internal auditors
- 4 *diligence*: incentive, motivation and perseverance

It is clear that the above determinants of audit committee effectiveness place major emphasis on the quality of members of the committees. Sufficient numbers of members, quality, expertise as well as the authority and support from management will have a beneficial effect on the performance of audit committees in the South African public sector. Bedard and Gendron (2006) evaluated the effectiveness of audit committees in three corporations using the following measurement criteria:

- audit committee composition
- audit committee authority
- audit committee resources
- audit committee diligence
- background of audit committee members
- quality of audit committee documentation
- matters emphasised in audit committee meetings such as:
  - financial statements
  - effectiveness of internal control
  - evaluation of internal and external auditing

The above criteria are key quality elements that will influence the functioning and effectiveness of any audit committee. There is again a major emphasis on member quality but they also identify five key responsibility areas, namely financial reporting, risk management, governance, internal control and the evaluation of the audit process (Bedard *et al.* 2004). Certain benefits will accrue to the organisation if the audit committee functions effectively. When these characteristics prevail in an audit committee, there will be definite advantages for the organisation. The benefits of an effective audit committee are listed by the National Treasury (2001:14).

- Independent internal audit activity, which operates efficiently and effectively, is ensured.
- Risk management practices are applied in the organisation.
- Sound corporate governance practices are applied.
- The system of internal control is adequate and functioning effectively.
- Fraud and corruption are being dealt with effectively.

According to Rainsbury (2004:5), audit committees with independent members appear to be more active, more involved in audit committee functions and less likely to be involved in actions that impinge on the quality of financial reporting.

## 5 Presentation and analysis of the results of the research

The first key finding deduced from the interviewees' responses is that there are major differences in the quality and effectiveness of audit committees across departments. Some national departments have model audit committees that comply with all best-practice requirements and function effectively, whilst a number of departments have ineffective audit committees that do not contribute to improved corporate governance in the departments. Data obtained from an interviewee from the Auditor-General indicate that 38% of the audit committees she is involved with, are functioning extremely effectively, 25% of the committees are average and 37% of the committees do not function effectively in terms of the required responsibilities and best practices.

The interviewee also indicated that a limited number of audit committees are essentially dysfunctional. Notwithstanding the virtues of audit committees and the existence of legislation for their establishment, there remains the overriding question of their effect on organisational accountability in departments. The perceived effectiveness of audit

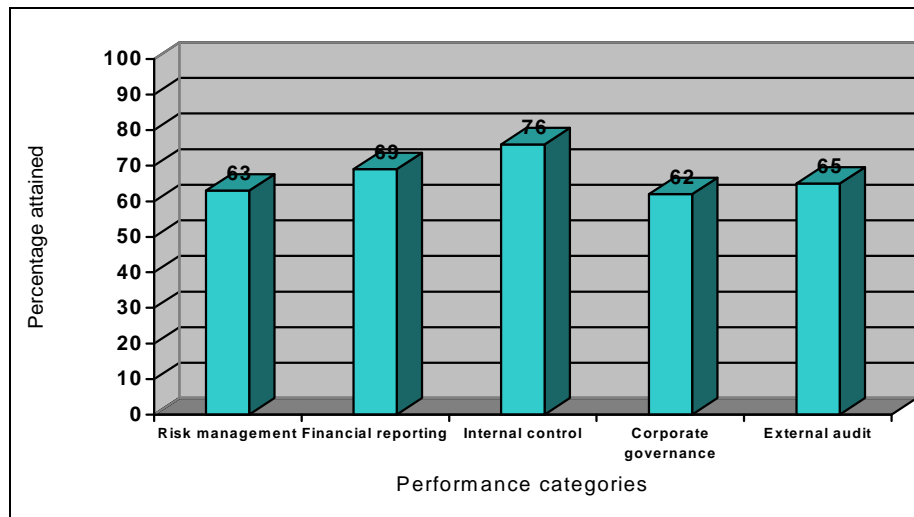
committees in the South African public sector was measured in terms of five key performance areas, identified on the basis of literature research. These functions, however, are also legal requirements and part of the Treasury Regulations (South Africa 2005:ch. 3).

The areas to be evaluated are

- risk management
- financial reporting
- internal control environment
- corporate governance and effective oversight
- external audit

An analysis of the results of the Likert-type scale measurement of the perceived effectiveness of public service audit committees yields the following:

**Figure 1 Effectiveness assessment (main categories)**



### **5.1 Risk management**

The audit committee is required to assess management's risk management processes and internal auditing and external auditing's coverage of these risks (South Africa 2005:8). Participants rated the perceived effectiveness of the audit committee's risk monitoring processes at 63%. There is a perception that the audit committees' discharge of their duties regarding the monitoring of risk management processes in the department needs to be drastically improved.

Perceived audit committee effectiveness in the overview of the risk management process of the department was measured using the following elements:



**Table 4 Overview of risk management processes**

Elements assessed	Perceived effectiveness measurement
1 Assessment of management's risk management processes	60%
2 Audit committee processes of communication with management and auditors with regard to understanding organisational risks	58%
3 Audit committee processes to assess the risks of material financial misstatements	68%
4 Audit committee's understanding of the department's key strategic risks and management's plans to address these risks	66%
5 Audit committee procedures to encourage frank dialogue with internal and external auditors about risk matters	62%

This research provides evidence that South African public sector audit committees need to improve their strategies and procedures for monitoring the key strategic and financial risks of their departments. In particular need of attention is their communication with management and auditors about risk matters.

## 5.2 Financial reporting and compliance

The perceived effectiveness of audit committees in their oversight over the financial reporting process of departments was rated at an average of 69%. The audit committee must evaluate management's financial reporting and compliance procedures. The performance with regard to these processes was rated by means of the following two elements:

**Table 6 Oversight over the financial reporting process**

Elements assessed	Perceived effectiveness measurement
1 Audit committee processes to obtain information relating to financial reporting issues, unusual transactions, performance against the budget	68%
2 Obtaining an understanding of critical accounting principles (Generally Recognised Accounting Practice)	70%

## 5.3 The internal control environment

It has been argued that audit committees should be responsible for overseeing management's assessment of risk. The audit committee can strengthen management's ability to identify and assess both internal and external risks (Turley & Mahbub 2001:12), as well as management's implementation of appropriate controls to mitigate these risks. It is further recognised that the audit committee can strengthen the internal audit activity in the department by providing a monitoring mechanism to assess the effectiveness of these controls (National Office of Audit and Accounting 2002:4). A key source of information regarding the effectiveness of the internal control system is the internal audit activity in the department. The quality of information the audit committee receives on the internal control structure of the department is directly related to the effectiveness of the internal audit activity. The key support functions of the audit committee include follow-ups on recommendations contained in the internal audit reports, as well as support for the internal audit activity in terms of appropriate budget allocations and staffing complements.

This effectiveness measurement was applied using the following criteria:

**Table 7 Internal control environment/internal audit activity**

Elements assessed	Perceived effectiveness measurement
1 The audit committee receives enough information to review and understand the department's system of internal controls	74%
2 The audit committee enquires about the experience and adequacy of staff in the internal audit activity and finance departments	63%
3 The audit committee reviews the annual internal audit plan	90%
4 The audit committee reviews management letters from internal and external auditing, to address significant issues	81%
5 The audit committee reviews management responses to the above- mentioned letters	77%
6 The audit committee assesses compliance effectiveness and other consulting services provided by the internal audit activity	69%
7 The audit committee evaluates compliance with the standards of the IIA	63%

The participants rated the perceived effectiveness of audit committees to monitor the internal control environment as being 76%. In terms of the criteria used, an important responsibility of the audit committee is to monitor the effectiveness and the quality of staff in the internal audit activity. Compliance with the Standards for the Professional Practice of Internal Auditing as set out by the Institute of Internal Auditors, is a legal requirement in South Africa in terms of the Treasury Regulations (SA 2005:ch. 3). The audit committee should therefore assess the degree of compliance of the internal audit activity against these set standards. Because of the high importance of this factor, this is an area in which audit committees should improve their involvement in the internal audit activity.

#### **5.4 Corporate governance and effective oversight**

There is a synergy generated by the responsibilities of audit committee members that brings about an improvement in corporate governance (Levy 1993:60). The fourth area of potential impact of the audit committee to be measured in this research is the perceived effectiveness of the audit committee in improving corporate governance and oversight in the government department. The overall evaluation of the performance of the audit committee in its contribution to corporate governance, as assessed by participating individuals, was rated at an average of 62%.

The criteria used to measure the performance were the following:

**Table 8 Contribution to corporate governance and oversight:**

Elements assessed	Perceived effectiveness measurement
1 The audit committee's orientation programme and processes to enhance members' understanding of their responsibilities, and of the accounting and reporting areas	37%
2 The audit committee's procedure to obtain meeting documentation and to ensure inclusion of applicable agenda items from audit, management and members	71%
3 The audit committee's review of significant issues prior to release of financial statements	74%
4 The audit committee's review of significant issues prior to the release of the annual report of the department	71%
5 The audit committee being informed of any cases of non-compliance or violations of regulations and laws	57%

An important finding of this research concerns the inability of individual members of audit committees to make a significant contribution to the functioning of the committee because of their lack of familiarity with the operational processes of the particular department and of the public service in general.

### 5.5 Relationship with external audit

Although the genesis of the public sector audit committee is different from general corporate audit committees (National Office of Audit and Accounting 2002:2), the functions are generic. In the public service, the audit committee must thus also provide support for the external audit function, that is, the Auditor-General. In particular, the audit committee must actively recognise the Auditor-General's independence, supporting the key audit findings and evaluations contained in the management letter issued to the department by the Auditor-General, and evaluating departmental responses to that letter. The audit committee also has to resolve any differences in opinion (filling the gap) between the external auditor and management (Gazzaway 2008:22).

The assessment was conducted on the basis of the following criteria:

**Table 9 Relationship with external audit**

Elements assessed	Perceived effectiveness measurement
1 Support from the audit committee for external audit	70%
2 Resolution of differences in opinion between management and external audit	70%
3 Review of the management letter issued by external audit	60%
4 Review of management's responses to the management letter	60%

In table 9 above an average perceived effectiveness of 65% was measured with regard to the support the audit committee provided for the external audit. In the interviews with staff from the Auditor-General, it was mentioned that, on the basis of the Auditor-General's finding, there is room for improvement in the follow-up of management's actions. Although most departments develop action plans to address the issues identified during the audit, the same findings recurred in successive years, suggesting that the plans were not implemented. During the interviews it emerged that in general, the audit committees tended to side with management in trying to remove negative remarks from the audit report. This could be ascribed to the fact that the audit committees wanted to be seen as having been effective in addressing audit issues and in improving the department's control system.

## 6 Conclusion

The research has shown that the majority of audit committees are not perceived as being ineffective. There is, however, room for improvement in all key areas of audit committee responsibilities. Areas that are perceived as most ineffective are the audit committees' monitoring of risk management and corporate governance in departments. The perception is that audit committees are more effective in their oversight over and support for the internal audit activities in departments. The research has been valuable in identifying which characteristics are evident in those audit committees that are perceived to be effective. These characteristics were identified from open-ended replies to questions in the questionnaires, and from the personal interviews conducted. The following are the key

characteristics of and activities performed by those committees that are deemed to be effective:

- the presence of the accounting officers at all audit committee meetings
- a decisive, knowledgeable and experienced audit committee chairperson
- a chairperson with an open and direct line of communication to the accounting officer (head of department)
- a chairperson with open lines of communication with the chief audit executive and external auditor
- members who are well qualified, prepare well for audit committee meetings and are committed to improving the department's operational and managerial effectiveness
- an orientation or professional development programme for new members to inform them of the operational and managerial situations in the department
- a strong, independent and well-resourced internal audit activity in the department
- senior management members who attend audit committee meetings and are willing to answer questions on managerial issues
- audit committee members who are prepared to scrutinise internal and external auditing reports and call management to account for their efforts to address the shortcomings identified during audit investigations
- convening pre-meetings with internal auditing, external auditing and management to obtain clarity on operational, financial and management situations underlying issues to be presented at the forthcoming formal meeting
- insisting that risk management be a standing item on the agenda, and that feedback should be received from the risk management committee
- insisting that financial reporting be a standing item on the agenda and that members should be briefed on any changes in reporting frameworks and Generally Recognised Accounting Practice.
- These are the characteristics of effective audit committees identified and agreed upon by all participants in this study. They are present in the committees in the public service that comply with best practice standards and are perceived to be contributing to improved corporate governance in their respective departments.

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