

CORPORATE GOVERNANCE AND RISK MANAGEMENT INDEX

AN INTERNAL AUDIT PERSPECTIVE



**The Institute of
Internal Auditors
South Africa**



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FOREWORD

There has been an unprecedented global focus on good corporate governance and risk management in recent years. The situation in South Africa is no different and is in fact likely to intensify in years to come.

The King Codes on Governance are widely recognised as having set the benchmark for corporate governance internationally, and South Africa often features strongly in global governance reports. As a case in point, the World Economic Forum's Global Competitive Report 2012-13¹ places South Africa first in the world in terms of the strength of its auditing and reporting standards as well as first for the efficacy of corporate boards. Yet, despite leading the world in setting best practice in governance, South Africa is slipping down the rankings in respect of competitiveness and levels of corruption. The WEF Global Competitiveness report also indicates that South Africa has dropped one spot to number 53 out of 148 countries. Transparency International ranked South Africa No. 69 in the Corruption Perception Index 2012 – a drop of five places compared to the year before.

There is no doubt that there are pockets of excellence in governance in South Africa, and the accolades are well deserved. However, there are also serious weaknesses in the implementation of best practice which accounts for the widespread perceptions about growing corruption and maladministration in the country.

As a result of the increasing importance of corporate governance and risk management in both today's business and public sector environments, oversight bodies such as boards and audit committees have placed huge expectations on internal auditors to provide independent assurance on the adoption and implementation of processes impacting on effective corporate governance and risk management. Internal auditors are in the unique position of having an independent and objective perspective on the performance of the organisation from a risk, governance and compliance standpoint, and are also able to lend their insights on these issues.

Through the Corporate Governance and Risk Index survey we were able to obtain the views of Chief Audit Executives (CAEs) regarding the state of governance and risk management within their organisations, and ascertain what their main priorities are. Since this survey was not a self-evaluation, it may be assumed that the perspectives of Heads of Internal Audit are not coloured by vested interests, and are therefore fairly reliable.

This report is intended to contribute towards our understanding of key strengths and weaknesses in the focus areas of corporate governance and risk management, and the survey will be conducted annually to enable us to track changes in the perceptions and opinions of CAEs who are important providers of assurance in this regard. It is our hope that not only internal auditors, but those in leadership positions, from senior and executive management to those serving on oversight bodies, will find the insights presented in this report to be of value.

I would like to sincerely thank all CAEs who participated in the survey as this valuable Index would not have been possible without their inputs.

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Chief Executive Officer
The Institute of Internal Auditors South Africa
November 2013*

¹ WEF Report, p. 325. See full report at <http://www.weforum.org/>



INTRODUCTION

Internal Audit's role in the Three Lines of Defence Model is focused on providing independent assurance. The First Line of Defence involves operational management who is *"responsible for maintaining effective controls and for executing risk and control procedures on a day-to-day basis"*². The Second Line of Defence belongs to the various risk management and compliance functions where they exist in an organisation. Typical functions include risks management, compliance, financial control, inspection, quality and security.

Internal auditors constitute part of the Third Line of Defence as they *"provide the governing body and senior management with comprehensive assurance based on the highest levels of independence and objectivity within the organisation"*³.

The Internal Audit Function (IAF) is therefore usually best placed to identify weaknesses within the control framework of the organisation. The oversight function for the Third Line is shared between senior management and the Board of Directors and its sub-committees. As critical guardians of governance, internal auditors are trained to be objective and independent-minded. In most cases this independent stance is reinforced by the fact that internal auditors report administratively to executive management and functionally to an oversight body such as the audit committee.

While the few research studies done in the past were aimed at establishing how South African companies are performing in the area of corporate governance and the implementation of King III, the respondents in those studies were drawn from senior and executive management as well as board members. Given that such respondents are reporting on their own performance to some extent, it was felt that it would be useful to canvass the opinions of Chief Audit Executives (CAEs) who are not implementers of governance policies and risk strategies, but play a more independent assurance function in these dimensions. The survey was thus aimed specifically at CAEs because they are the most senior and experienced internal auditors who interact frequently with oversight bodies as well as executive and senior management. Where the CAE is a member of the organisation, they to have a comprehensive, well rounded perspective on the performance of the organisation.

Therefore the central assumption of this study is that the opinions of internal auditors are especially weighty since they have a comprehensive inside view of the organisation, yet are detached enough to provide an honest, unbiased appraisal.

It is important to note that the main purpose of the survey was to create a baseline Index, for purposes of future comparisons. It was not designed to be an in-depth research study into the issues raised through the questions. Nevertheless, as this is intended to be an annual survey, it could prove to be an invaluable yardstick to track overall performance in the fields of corporate governance and risk management.

² IIA Position Paper: The Three Lines of Defence in Efficient Risk Management and Control, January 2013, p3

³ IIA Position Paper: The Three Lines of Defence in Efficient Risk Management and Control, January 2013, p4

EXECUTIVE SUMMARY

The three King Reports on Corporate Governance have elevated the profile of corporate governance and risk management, and is internationally acknowledged as a benchmark for best practice. These principles have become fundamental to organisations in both the private and public sectors and consequently, many organisations have taken action to ensure that corporate governance and risk management are appropriately and effectively applied.

This report reflect the views of Chief Audit Executives, who are well positioned to provide an impartial view of the state of corporate governance and risk management, as they typically provide independent assurance on governance, risk and control within the organisations they serve.

The IIA SA's Corporate Governance and Risk Index survey is the first of its kind and is intended to provide a baseline for the measurement of performance in these areas for the country as a whole, since it surveys all economic sectors. The table below summarises overall responses to the single-response multiple choice questions in the survey.

Table 1: Overall summary of results

Question/Issue	Strongly disagree	Slightly disagree	Neutral	Somewhat agree	Strongly agree	Don't know
Oversight body sets tone of zero tolerance	5.07	2.76	4.61	19.82	67.28	0.46
Ethics and integrity are important to the organisation	4.15	4.61	5.53	19.82	65.90	0.00
Organisations understand and consistently apply King III	4.15	9.68	7.83	31.34	46.54	0.46
The oversight body provides clear strategic direction	3.23	4.61	7.83	29.03	53.00	2.30
Adequacy of risk management	3.69	12.90	8.29	34.56	40.55	0.00
Internal audit has a sufficient degree of independence	3.69	2.76	4.61	13.82	74.65	0.46
Use of combined assurance framework	4.61	11.98	10.60	38.25	34.56	0.00
Audit Committee effectiveness and value add	5.07	4.61	9.22	23.96	53.46	3.69
Leadership's understanding of & valuing of internal audit	4.15	8.76	5.99	26.27	53.92	0.92
ICT alignment to the objectives of the organisation	7.83	12.90	14.75	30.88	31.80	1.84

The key themes derived from the survey are as follows:

1. The most positive aspect of corporate governance and risk management in South Africa is that three quarters of respondents across all sectors report that their **internal audit functions are sufficiently independent**. This implies strongly that in most organisations there is no undue influence or interference exerted that could impair the ability of internal audit to provide independent assurance over corporate governance, risk and control.
2. The majority of organisations are under-performing when it comes to **risk management**, thus there is huge room for improvement. Less than half (41%) of respondents were strongly confident that their risk management was adequate. Given the importance of risk management, it is a concern that almost 60% of respondents either do not believe that their risk management practices are adequate or else they cannot say with certainty that their risk management is adequate.

3. The area of greatest challenge for South African organisations lies in the alignment of **Information Communications Technology** and in managing ICT related risks.
4. Adherence to the **King III** code of good governance is not as strong as one might have expected. Less than half of all respondents (47%) feel that their organisations have a strong level of understanding and implementation of the King III governance principles.
5. The aspect of King III recommendations that many organisations find most challenging is the full implementation of **Combined Assurance**, with a lower than expected 35% of respondents strongly agreeing that they were competent in using this framework.
6. The **top five focus areas for organisations** according to CAEs over the next three years, in order of priority are: ICT, Regulatory and Compliance issues, Human Resources, Ethics and Leadership as well as Fraud and Corruption.

RESEARCH METHODOLOGY

Six hundred CAEs on the IIA SA database were targeted for the survey. A self-administered web-based survey questionnaire was developed to address the research objectives, bearing in mind that respondents would be drawn from all economic sectors. It was essential that the questions be worded in as generic a manner as possible. It was also critical that the survey elicited the most honest responses. Consequently, no personal demographic data was asked for. Furthermore, the questionnaire was kept as short and crisp as possible so as to encourage a higher level of participation. Over the period 26th July 2013 to 20th September 2013, the Institute of Internal Auditors of South Africa received responses from 217 CAEs in respect of the Corporate Governance and Risk Index (CGRI) survey.

Outline of the survey questionnaire

The survey consisted of two demographics-related questions, 10 multiple choice questions and two open-ended questions. The 10 multiple choice questions plus the two open-ended questions covered the following areas: the role of oversight bodies (3 questions), ethics (1), King III (1), risk (3), internal audit (2), combined assurance (1) and ICT (1). The single-response multiple choice questions were structured in such a way as to establish a respondent's level of agreement with a given statement. The six choices available to respondents were as follows: strongly disagree, slightly disagree, neutral, somewhat agree, strongly agree and don't know.

SURVEY RESULTS

Demographic data

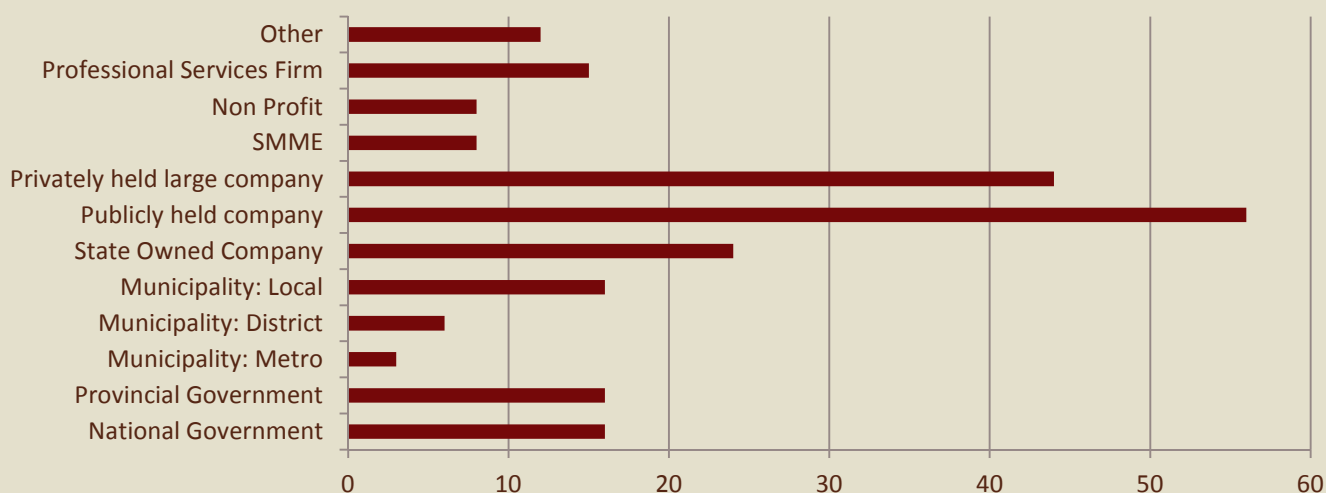


Figure 1: Sectors respondents work in (%)

The largest groups of respondents worked in the public sector (a total of 25% - not including state owned companies), as well as publicly held companies (also 25%) which accounted for a quarter of the respondents. The third largest grouping worked for privately held large companies, followed by state-owned companies.

Survey Responses

Please note that results for Metro municipalities has been left out because there were too few respondents (3)

Question: The Oversight body (such as the Board or Council), sets a clear tone of zero tolerance toward unethical behaviour, fraud and corruption in our organisation and acts accordingly

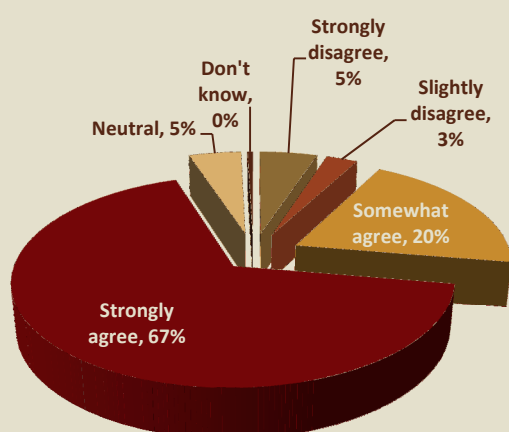


Figure 2: Breakdown of various responses

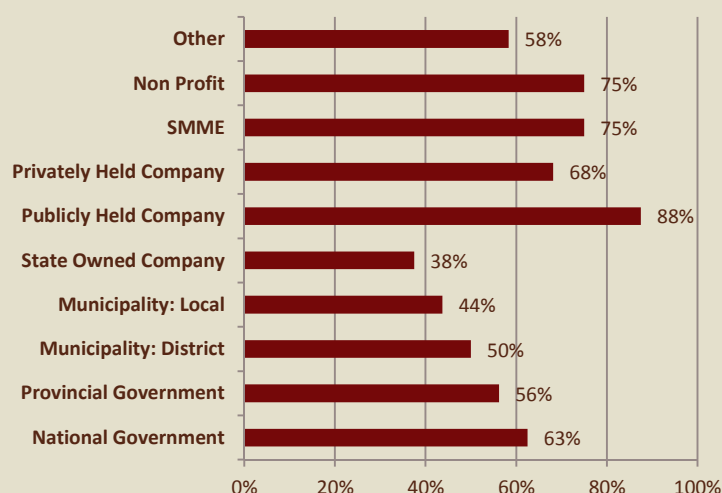


Figure 3: Respondents per sector that strongly agree with statement

Approximately two thirds (67%) of respondents strongly believed that their oversight body sets a tone of zero tolerance towards unethical behaviour, whilst 20% agreed that this was the case to some extent. In total, 8% respondents strongly or slightly disagreed with this statement. Publicly held companies appear to have the strongest oversight bodies in terms of setting the right tone for good governance. This may be a result of the Johannesburg Stock Exchange (JSE) requirements and regulatory requirements for professional firms.

Question: Ethics and integrity are an important part of our organisational culture

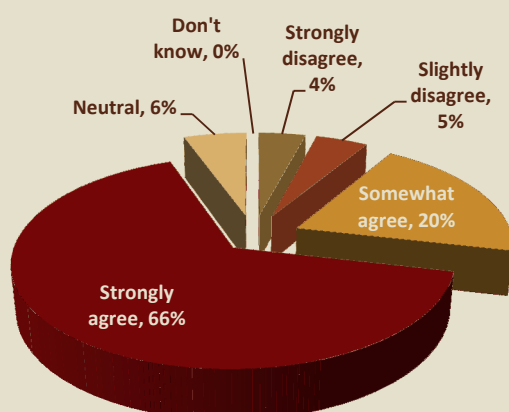


Figure 4: Breakdown of various responses

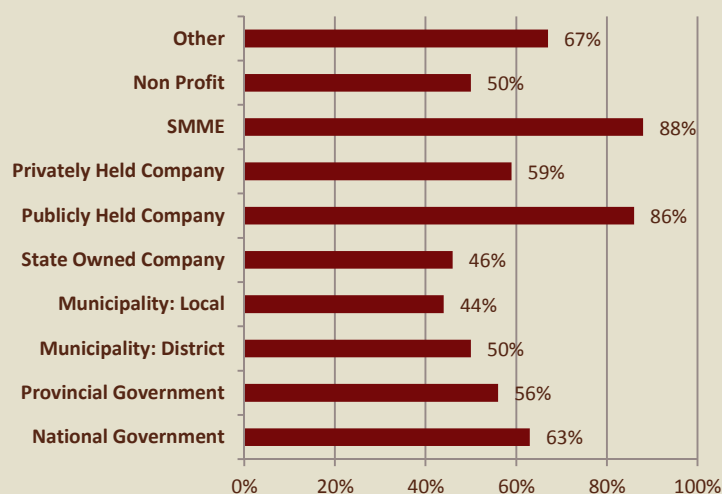


Figure 5: Respondents per sector that strongly agree

Two thirds of respondents strongly agree that ethics and integrity are integral to their organisational culture. A further 20% somewhat agree, and a total of 9% disagree strongly or slightly. The results suggest that the ethical culture is strongest at SMMEs, and lowest at local municipalities (44%), district municipalities (50%) and state-owned companies (46%).

Question: My organisation consistently applies strong understanding of and commitment to implementing good corporate governance principles as outlined in King III

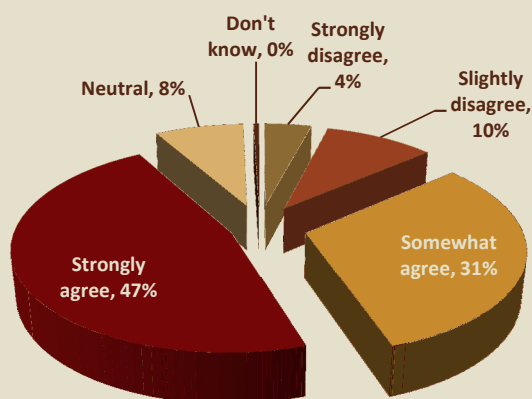


Figure 6: Breakdown of various responses

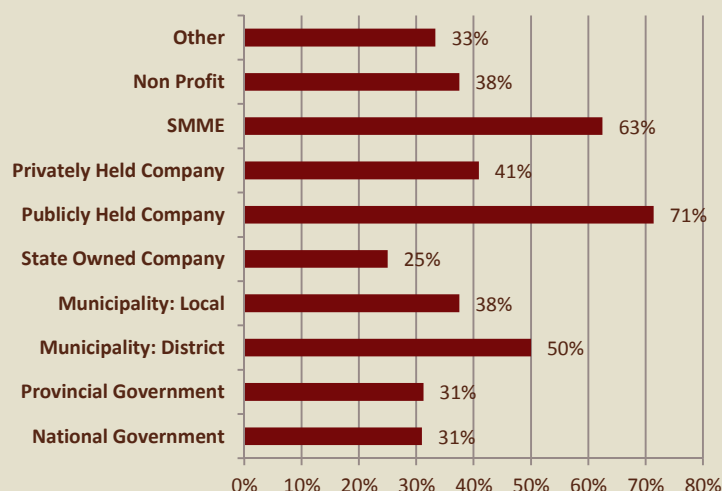


Figure 7: Respondents who strongly agree

Less than half of respondents (47%) strongly agreed that their organisations consistently applied King III guidance, with a further 31% somewhat in agreement. A significant proportion of respondents (14%) strongly disagreed or slightly disagreed with the statement. Adherence to the principles of King III appears to be strongest at publicly held companies where 71% strongly agreed with the statement. Application of King III is compulsory for this sector as per the JSE requirements – except where the “comply or explain” principle applies. Respondents at state-owned companies (25%) were least likely to strongly agree with the statement.

Question: Our Oversight body (such as the Board or Council) provides clear strategic direction and creates the right environment for management to achieve the objectives of our organisation

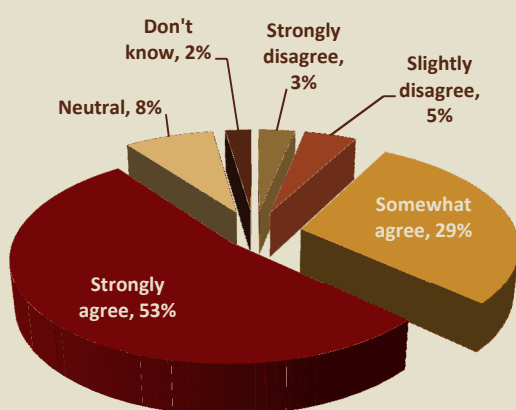


Figure 8: Breakdown of various responses

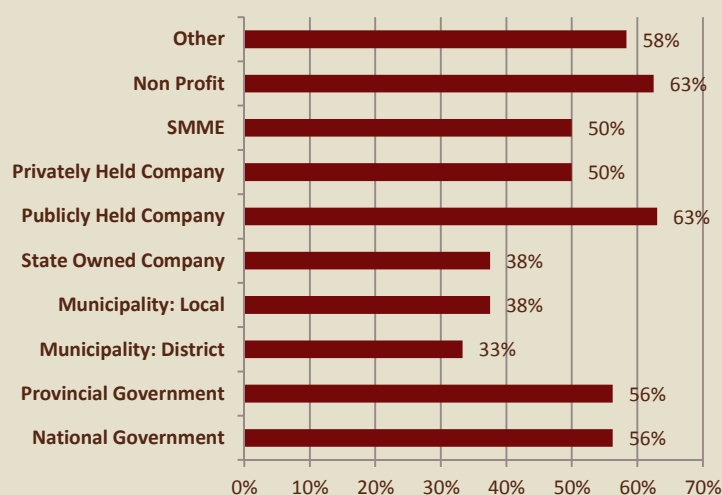


Figure 9: Respondents who strongly agree

Just over half of all respondents (53%) expressed a strongly positive view of their oversight body’s ability to provide clear strategic direction and to create the right environment for management to achieve organisational objectives. A further 29% partially agreed with that statement, while a total of 8% either fully or slightly disagreed. Publicly held companies and Non Profit organisations rated their oversight bodies highest in this regard, with 63% of respondents strongly in agreement. The lowest levels of strong agreement were in the public sector, with results as follows: district municipalities (33%) and local municipalities (38%). Respondents in state owned companies were also only 38% strongly in agreement.

Question: The process for identifying, assessing, managing and monitoring risks within our organisation is adequate and covers all the important areas of our organisation (bearing in mind the distinction between the responsibility for risk management and Internal Audit.)

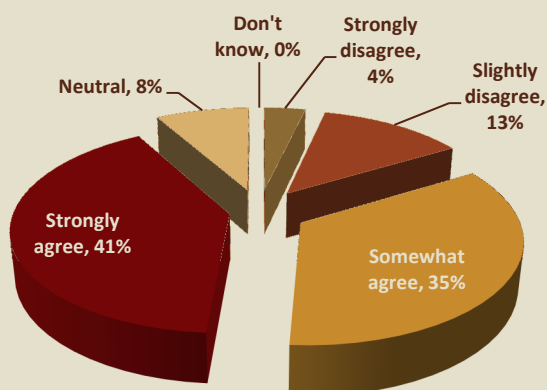


Figure 10: Breakdown of various responses

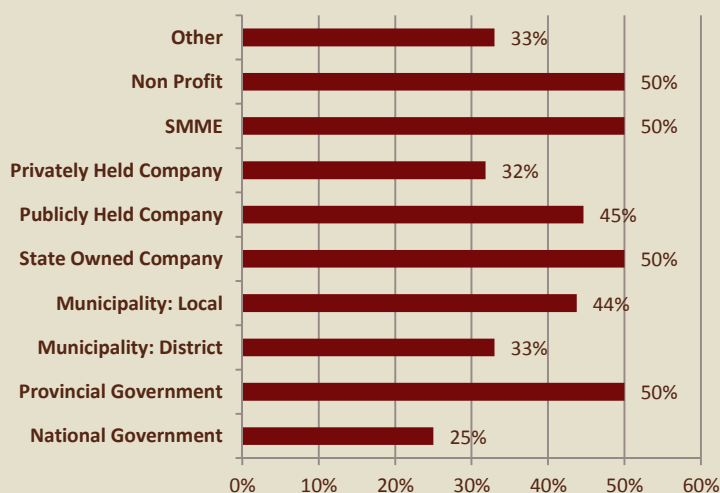


Figure 11: Respondents who strongly agree

Only 41% of respondents strongly agreed that their organisation's risk management processes were adequate, with a further 35% somewhat in agreement. A total of 17% slightly or completely disagreed with the statement. Non Profits, SMMEs, state owned companies and provincial government respondents were most strongly positive at 50%, while the lowest level of strong agreement was at national government level where only a quarter of respondents chose this response.

Question: Within our organisation Internal Audit has a sufficient degree of independence to enable it to execute its duties without undue influence or interference

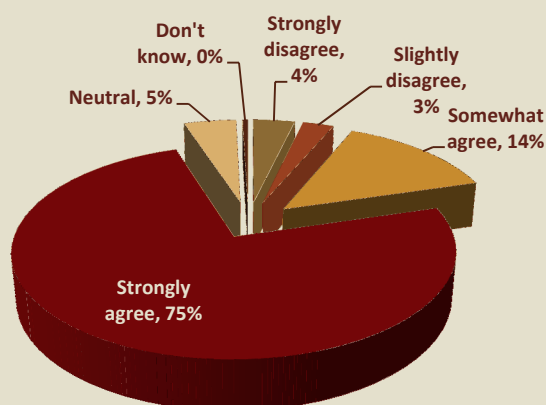


Figure 12: Breakdown of various responses

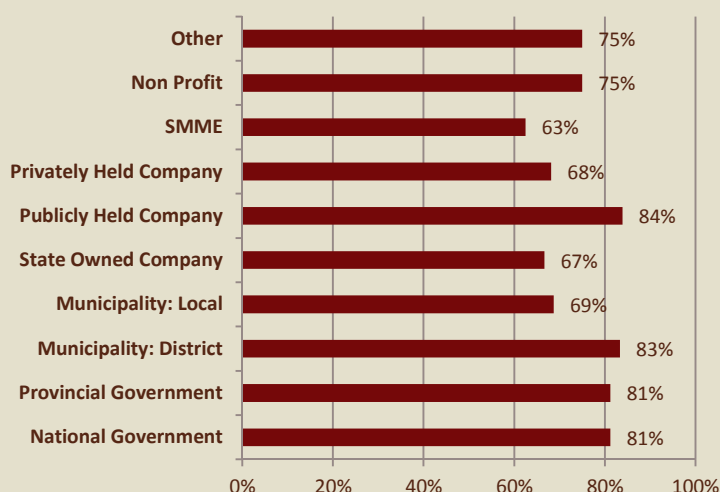


Figure 13: Respondents who strongly agree

Three quarters of survey respondents strongly agree that internal audit is accorded a sufficient degree of independence in their organisations. A further 14% partially agreed and 7% disagreed fully or slightly. Respondents at publicly held companies were most positive (84%), followed by public sector respondents: district municipalities (83%) and national and provincial governments (81%).

Question: Our organisation uses a combined assurance framework to provide a co-ordinated approach to assurance activities

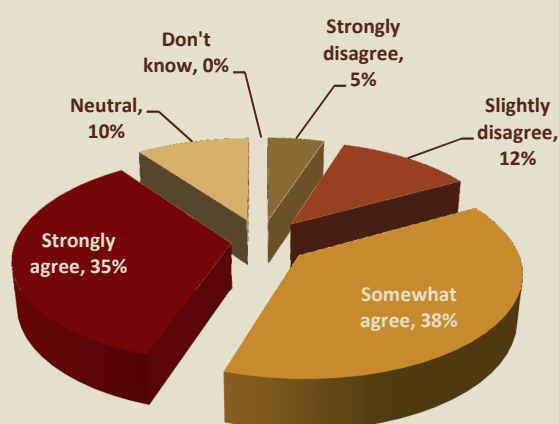


Figure 14: Breakdown of various responses

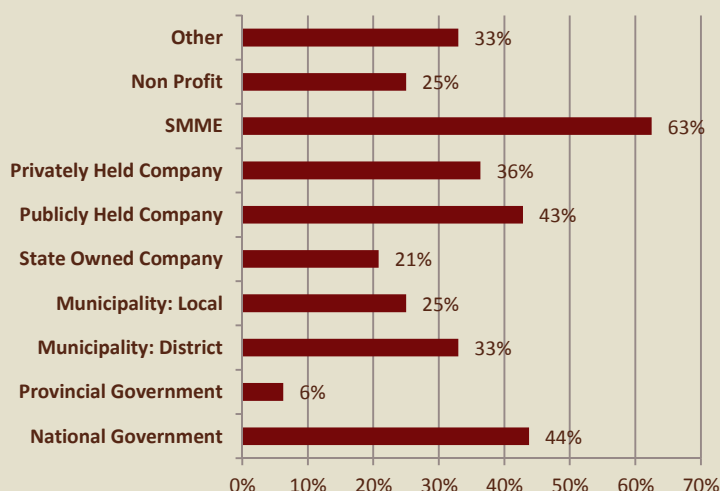


Figure 15: Respondents who strongly agree

A rather low 35% of respondents strongly agreed that their organisations used the combined assurance model, with another 38% somewhat in agreement. A total of 17% were strongly or slightly in disagreement with the statement. SMMEs (63%) most strongly agreed that they used a combined assurance framework. Only 6% of respondents in provincial government strongly agreed compared to national government (44%), district municipalities (33%) and local municipalities (25%).

Question: The Audit Committee is effective in its oversight role and adds real value to the organisation

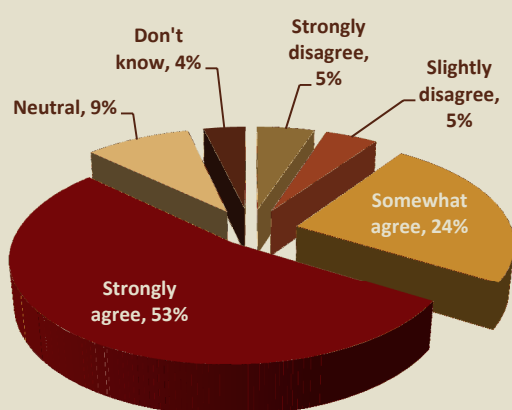


Figure 16: Breakdown of various responses

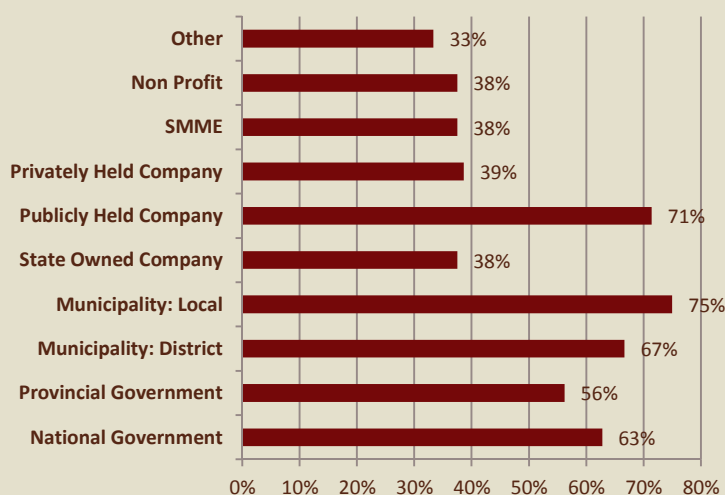


Figure 17: Respondents who strongly agree

A total of 53% of respondents feel strongly that their Audit Committees are effective at executing their oversight roles and that they make a valuable contribution towards the organisation. At the other end of the scale, 10% either fully or slightly disagreed with the statement. Public sector respondents are rather more positive than their private sector counterparts, with the strongly agree scores as follows: local municipalities (75%), district municipalities (67%), national government (63%) and provincial government (56%). A sizeable 71% of respondents from publicly held companies agreed strongly. State owned companies, Non-profit organisations and SMMEs expressed least confidence in their audit committees, with only 38% strongly agreeing.

Question: The leadership in my organisation displays a good understanding of the role and value of internal audit

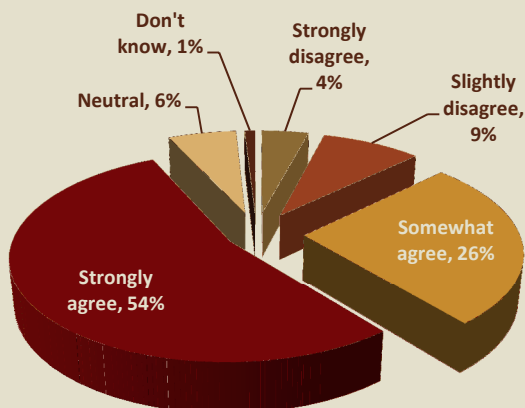


Figure 18: Breakdown of various responses

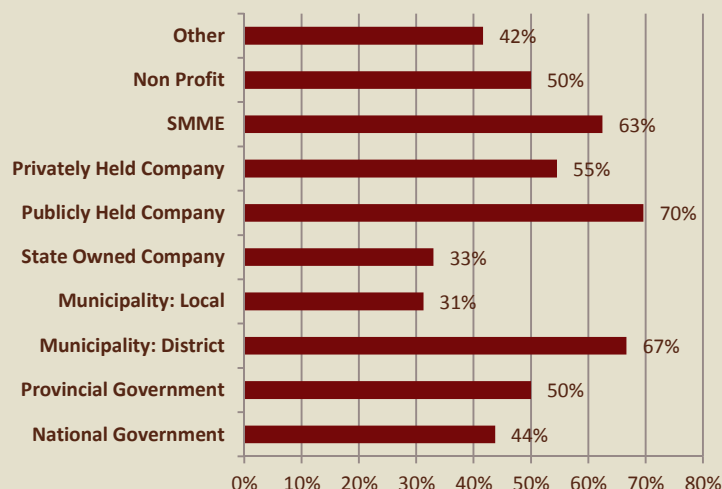


Figure 19: Respondents who strongly agree

More than half of all respondents, (54%) strongly agree with the view that the leadership of their organisations has a good understanding of internal audit and values the contribution it makes, whilst 26% partially agree and a total of 13% either strongly or slightly disagree. Respondents from publicly held companies agree most strongly that their leadership understands and values internal audit. Respondents at local municipalities feel that there is a serious lack of understanding and appreciation of the value of internal audit - only 31% strongly agree.

Question: ICT is aligned with the performance and sustainability objectives of my organisation

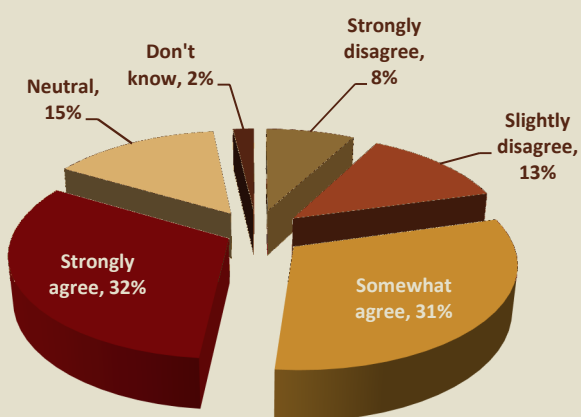


Figure 20: Breakdown of various responses

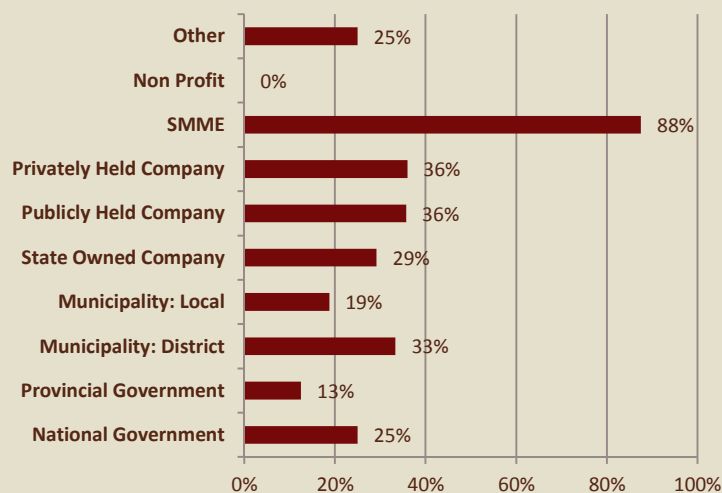


Figure 21: Respondents who strongly agree

This is clearly the weakest area for most organisations. Only 32% strongly agree that their Information Communications Technology is aligned to the performance and sustainability objectives of the organisation, and a total of 21% either strongly or slightly disagree with that statement. SMMEs feel most confident of the strategic alignment of their ICT with 88% in strong agreement. The results for local and district municipalities point to a serious problem with the strategic alignment of ICT with organisational objectives. In fact, there were more respondents that disagreed with the statement than those who agreed. For local municipalities, 19% strongly agreed, 13% somewhat agreed, 31% strongly disagreed and 19% slightly disagreed. District municipality results were as follows: 33% strongly agreed and 66.66% either strongly disagreed or slightly disagreed. (some results not on graph)



Open-ended questions

Respondents were free to answer the two open-ended questions according to their own personal interpretations of the question. As a result, the answers given vary greatly – from very vague, broad answers to very specific issues pertaining to their particular organisation, industry or sector. Consequently, it was no easy matter to neatly categorise and analyse the data. Nevertheless, there were certain trends that clearly emerged based on the numbers of responses relating to particular issues. The responses were clustered into the broad categories based on a general “risk universe”, as listed below:

1. Operational
2. Strategic
3. Financial
4. Compliance
5. Other

The main categories were broken down further into sub-categories.

Question: List the top 3 categories of emerging risk in your organisation

Top Emerging risks

A. General risks

General risks refer to a broad spectrum of issues mentioned that relate to a vast topic such as the economy. The top risks according to the number of times the topic was mentioned, are as follows:

1. Financial risks (60 mentions)
2. Business continuity and growth related risks (50)
3. Global and national economy (43)
4. Socio-political issues (43)
5. Planning and Resource Allocation (34)

B. Specific risks

Specific risks are perhaps of greater relevance as they relate to a very narrow category such as Information technology or combined assurance. The top risks were:

1. Human Resources (67 mentions)
2. Information Technology/ICT (54)
3. Compliance (53)
4. Fraud and Corruption (25)
5. Supply Chain Management (15)

Question: List the top 3 governance and risk focus areas that your organisation will work on over the next 3 years

Top focus areas

A. General risks

1. General governance issues (65 mentions)
2. Operational processes (63)
3. Business continuity and growth (49)
4. Financial (44)
5. Quality assurance issues/Planning and Resources Allocation issues (21 each)



B. Specific risks

1. Information Communications technology (ICT) – (66 mentions)
2. Compliance (50)
3. Human Resources (38)
4. Ethics and Leadership issues (30)
5. Fraud and Corruption (15)

CONCLUSIONS

Before drawing any conclusions from the data, it should be mentioned that the *benchmark* used to determine how well we are performing as a country, is a *75% overall strongly positive response* to each multiple choice question about governance and risk management – this corresponds to the option “*strongly agree*”. Given that by its very nature, governance and risk management to be truly effective, must attain high standards, it was decided to favour the option of using “*strongly agree*” as the aspirational benchmark against which to gauge the current and future reported levels of good governance and effective risk management.

It should also be noted, that for the purposes of analysis the scores for the 3 respondents from metro municipalities have been disregarded as they comprise the smallest group. This number is not statistically significant, and their results may somewhat skew the analysis.

The first and most obvious conclusion to be made is that on the whole, respondents in the private sector rated the state of governance and risk management at their organisations substantially higher than their public sector counterparts. The only area where this appears to be the exception is the issue of whether audit committees were effective in its oversight role, and added real value to the organisation. (See point 7 below).

Relative Strengths

1. The strongest positive governance indicator is the **level of independence accorded to internal audit**. This was the only area where at least 75% of respondents expressed “strong agreement” with the given assertion. Respondents overwhelmingly agreed that internal audit was allowed to be sufficiently independent, thus enabling the function to execute its duties without undue influence or interference.
2. The second most positive factor emerging from the data is that just over two thirds of respondents indicate that their **oversight bodies do set the correct tone of zero tolerance** of unethical behaviour. This correlates with the 66% of respondents who strongly agreed that ethics and integrity are important to their organisations. Despite this, fraud and corruption was rated the 4th most important specific risk governance and risk factor that their organisations would be focusing on over the next three years.

Relative weaknesses

3. **Information Communications Technology** management was clearly the weakest risk and governance area. Only 32% strongly agreed that their ICT was aligned to the performance and sustainability objectives of the organisation. This is corroborated by the fact that ICT was ranked as the top priority for the next three years, making it an area where better strategy alignment, management and skills are urgently required.
4. The **Combined Assurance framework** as required by King III is something that most organisations are still struggling to implement fully, as only 35% of respondents strongly agreed that they were competent in using this framework. This issue also emerged quite strongly in the open ended questions.
5. Organisations in South Africa can certainly do much better at **risk management**. Surprisingly, less than half (only 41% of respondents) were strongly confident that their risk management was adequate. This implies that almost 60% of respondents either do not believe that their risk management practices are adequate or else they cannot say with certainty that their risk management is adequate. It is also interesting that none of the categories of respondents “strongly agreed” above 50%, meaning that this is a weakness in both public and private sectors.



6. It seems that less than half of all organisations in the country (47%) have a strong level of understanding and implementation of the **King III** governance principles. In other words, more than half of all respondents believe that the application of King III corporate governance principles can be either enhanced or adopted within their organisations. The best performer in this regard is publicly held companies of which 71% of respondents strongly agreed that they are doing well at implementing King III. For the most part, it would appear that the implementation of King III is fairly weak, although it should be remembered that in the public sector, adherence to the Public Finance Management Act (PFMA) tends to take precedence over King III, which may account somewhat for the low scores. Nevertheless the private sector and state owned companies did not attain acceptably high standards either.
7. Little more than half of all respondents (54%) strongly agreed that their **audit committees were effective**. While this is not good enough, it should be noted that 75% of respondents at local municipalities, 67% at district municipalities and 63% at national government strongly agreed that audit committees were effective and added real value. This result, which is generally higher than for the private sector, is somewhat counter-intuitive in light of the Auditor-General's reports which consistently point to weaknesses in governance at local government level. The result is also out of alignment with public sector respondents' answers to other questions relating to the tone set by the audit committee, risk management, King III and so on - thereby suggesting that there may exist a dynamic that is worth exploring further.
8. Another issue that deserves to be highlighted is that a large number of organisations intend to focus on dealing with **regulatory change and compliance** issues over the next three years. This emerged as the second most pressing issue to focus on and could very well be as a result of the consequences of the global financial crisis.
9. After ICT and Compliance related matters, respondents highlighted the lack of adequate **human resources** as the third most important focus area for the coming three years.

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