

Review

Internal audit activities performed in South Africa

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This study was conducted to determine the perception of the chief audit executive as head of the internal audit function, on the internal audit activities that should be performed (current and future) within South African companies after which the findings were compared with the international perception in this regard. Data was also obtained on whether internal audit activities were performed in-house or were outsourced; the importance of the internal audit activities, senior management's rating of the value added, the internal audit approach followed, and whether the internal audit standards were being complied with. A statistical analysis was performed on data that was obtained from questionnaires and interviews. This study targeted 30 chief audit executives, and to a lesser extent 30 Chief Executive Officers/Chief Financial Officers/Chief Operating Officers, of large South African listed companies. The results prove that chief audit executives perceive themselves as performing their internal audit activities according to the internal audit *Standards* and that they satisfy the needs and expectations of their companies. The internal audit profession, its clients and internal audit educators may benefit from the study in the planning of future internal audit activities and educational programmes respectively.

Key words: Consulting activities, fraud investigation activities, internal audit function, internal audit activities, internal audit standards, internal audit services, risk management.

INTRODUCTION

Internal audit is a relatively young and rapidly growing profession. In South Africa (SA) the rapid growth of the internal audit profession is firstly attributable to the mandatory requirement for an IAF by South African public sector legislation (SA, 2000; SA, 2003) and secondly the recommendation of the King Reports on Corporate Governance (IOD, 2009) for the private sector. It is also a listing requirement for companies listed on the JSE Limited to comply with the King Reports on Corporate

Governance (JSE, 2009). Apart from the above, the requirement to have an IAF is not directly legislated for the private sector in South Africa.

The rapid growth in the profession prompted the IIA, an international body, concerned with the continuing professional development of the individual internal auditor and the internal auditing profession (Coetzee and Du Bruyn, 2001), to regularly review the guidance for internal auditing. This led to the development of the International Professional Practice Framework (Standards). The Standards are regularly revised and updated to keep the profession informed with regard to the latest technological developments and the demands or needs of the internal audit engagement clients (Cooper, Leung and Wong, 2006; IIA (SA), 2009).

The aforementioned resulted in the *Standards* requiring of internal auditors to perform certain activities in respect of risk management, fraud, governance and related matters (IIA, 2007:3-4). Even though the IIA provides guidance in respect of the activities that internal auditors are expected to perform, a need was identified to determine the views of the CAEs on the activities that should

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Abbreviations: CAE, Chief Audit Executive (head of the internal audit function); CBOK, Common Body of Knowledge of the IIA; CE, Chief Executive Officer/Chief Financial Officer/Chief Operating Officer; IIA, Institute of Internal Auditors; IIA RF, Institute of Internal Auditors Research Foundation; IPPF, International Professional Practice Framework (*Standards*); IAF, Internal Audit Function; JSE, Johannesburg Securities Exchange; SOX, Sarbanes-Oxley Act, 2002.

be conducted by their IAF. This research attempts to seek answers to the research questions listed in the following section.

RESEARCH QUESTIONS

- What are the current internal audit activities that are performed by the in-house and outsourced IAF?
- What are the future internal audit activities that are expected to be performed by the in-house and outsourced IAF?
- How do the South African respondents' perception of the internal audit activities performed compare with the international perception?
- What internal audit activities are performed by the in-house and outsourced IAF and what are performed by external parties?
- What is the importance of the various internal audit activities?
- How do the senior management rate the value added by these internal audit activities?
- What is the internal audit approach being followed by the IAF?
- Do the IAF comply with the standards?

LITERATURE REVIEW

During recent years internal auditing has evolved from an accountancy based profession to a management oriented profession – striving to assist senior management of the organisation in accomplishing their operational objectives (Anderson, 1996; Enyue, 1997; Nordin van Gansberghe, 2005:69). This evolution of the profession also led to an increased level of skills and competencies required of internal auditors (Sawyer, Dittenhofer and Scheiner, 2003:864). This phenomenon is supported by the most recent definition of internal auditing, issued by the IIA. The IIA defines internal auditing as an “assurance and consulting activity” that is “designed to add value” and “...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” (IIA, 2007: xxix). As a result of the evolution from an accountancy based to a mainly management and risk oriented function, the definition of internal auditing that forms part of the International Professional Practice Framework (IPPF) of the IIA had to be adapted to keep up with global changes in expectations of internal auditors and the rapid growth of the internal audit profession (IIA, 2009). In addition major events such as corporate scandals also had a significant influence and impact on the direction of the types of activity IAFs provide globally (IOD, 2009).

An expectation gap emerged as a result of the evolution of the internal audit profession and the fact that the IAF is regarded as a non-core function of the company

(Weingardt, 2001). The expectation gap is between the IAF activities expected by stakeholders and the activities the IAF can actually provide (Weingardt 2001). The IIA realised that in order to address the gap, organisations and the IIA should take a fresher look at the potential value of internal auditing.

Apart from the expectation gap that emerged, the increased demands for IAF services placed strains on the available resources of IAFs. These resource limitations led to the co-sourcing or outsourcing of certain internal audit activities (Caplan and Kirschenheiter, 2000; PWC, 2006; Rittenberg and Covaleski, 1997). Large accounting firms regard internal audit services as an important alternative growth opportunity and aggressively market their services to their audit clients and other companies (Caplan and Kirschenheiter, 2000:394; Swanger and Chewing, 2001:116). Their marketing strategy is based on the high quality of the services they can offer (Anderson 1996). This study investigates and compares in-house and outsourced activities of IAFs.

The IIA Research Foundation (IARF) has funded the global 2006 CBOK study which was conducted amongst its members to “broaden the understanding of how internal auditing is practiced throughout the world” (IIA, 2006: 01; IARF 2006). The main aim with the CBOK 2006 study was to enable the IIA and its institutes to monitor the profession's involvement in achieving the ideal standing throughout the world (IIA, 2009).

The CBOK study resulted in a comprehensive database that contains information on the Institute of Internal Auditors' (IIA) International Professional Practice Framework (Standards), the state of the IAF, human resources, technical and non-technical skills, internal auditor competencies and the emerging roles of the IAF (IIA 2006:01; IARF 2006). The scope of the CBOK 2006 study was limited to the members of the IIA only (IIA 2006). This research, limited to 30 of the larger listed companies in South Africa, is not limited to the membership of the IIA, but includes responses of senior management and CAEs.

IIA standards

Members of the IIA are required to conduct internal audit engagements according to the Standards (IIA, 2007:3-4). The Standards are divided into Attribute Standards (AS) and Performance Standards (PS). The Standards provide guidance on both assurance and non-assurance or consulting services to be performed by internal auditors (IIA, 2007: 4).

AS 1000 provides guidance to internal auditors in respect of the purpose, authority and responsibility of the IAF and states that it must be formally documented in the internal audit charter. *Standards* 1000.A1 (assurance services) and 1000.C1 (consulting services) state that the nature of the assurance and consulting services that the IAF performs must be defined in the internal audit charter

(IIA, 2007: 7). As the Standards require that the internal audit charter must be approved by the board (IIA, 2007: 7), it could be accepted that senior management gives its full support to the activities of the IAF that are included in the annual audit plan. The results of this study could provide insight into the views of senior management and the CAEs on the nature of support provided in respect of internal audit activities provided or expected to be provided by IAFs.

When planning internal audit activities, internal auditors are required to consider the risks and the adequacy and effectiveness of the risk management process that resides within the scope of the engagement (Standards 2200, 2201 and 2210. A1; IIA, 2009: 31-32). Testing for compliance with legislation, policies, rules and regulations is included in the assurance services provided by IAFs. Where organisations do not comply with legislation, policies, rules and regulations it could also pose threats or risks which the IAF should communicate to senior management and should therefore form part of the annual audit plan (Hass, Abdolmohammadi and Burnaby, 2006:836-841). Internationally increasingly more IAFs make use of risk methodologies in the planning of internal audit engagements (Allegrini and D'Onza, 2003; Anderson and Leandri, 2006; PWC, 2008a:16; PWC, 2008b:31). The IIA, amongst others, defines internal auditing as a value adding activity (IIA, 2007:xxix) and IAFs must therefore align themselves strategically with the needs and priorities of senior management and external auditors when planning their annual internal audit activities (Hass, Abdolmohammadi and Burnaby, 2006: 839).

The IAF has become one of the tools readily available to management of organisations, through the conduct of various internal audit activities, providing the shareholders or investors, boards of directors, senior management and other stakeholders in organisations with reasonable assurance that their respective interests or investments in the organisation are protected (Enyue, 1997: 205). These assurance services (as well as consulting services) are meant to strengthen the governance and control processes of the organisation. In addition to assurance provided, senior management relies on the IAF for guidance and assistance (consulting services) with regard to good corporate governance, risk management and effective internal control systems (IIA, 2007: xxix; Coetzee and de Bruyn, 2001: 63).

Where companies have ties with United States of America (USA) companies, they will have to adhere to the Sarbanes-Oxley Act of 2002 (SOX) (SOX 2002). The consequence of this was that substantially fewer resources were available to operational audits and consulting activities (Hass, Abdolmohammadi and Burnaby, 2006: 837-838). Although this study did not investigate the nature of formal ties of the 30 larger South African listed companies with companies in the USA, the regulatory environment in the USA (the SOX) could also impact on the extent of internal audit activities performed by IAFs of South African companies. The SOX shifted the focus of

internal audit activities from a preventative to a detective function. Partnering with senior management became more important in specifically the internal audit approach, which shifted to be more management oriented and risk based (Hass, Abdolmohammadi and Burnaby, 2006:838; PCAOB, 2004). The result of this regulatory climate in the USA gave rise to the phenomenon that more resources of the IAF is dedicated to compliance type services in respect of the SOX requirements.

RESEARCH METHODOLOGY AND LIMITATIONS

The research methodology followed in this study is explained in the general introduction section to this special edition of the journal. A comparison was also done between the data obtained from this study and that of the CBOK study conducted in 2006.

One of the limitations of this study is that it did not include an investigation into the perception of the stakeholders outside of the IAF. The study, however, did investigate the IAF's adherence to the Standards, which are regularly revised and the perceptions of senior management on the value added by IAFs, through the conduct of specific internal audit activities. A further limitation to this study is that formal ties of the companies included in the sample with companies in the USA were not investigated. As a result the effects and impact of SOX were not included in the scope of this study.

RESULTS AND DISCUSSIONS

The data presented in the figures and tables below provide an overview of the general activities of the IAF. It is primarily based on the perceptions of the CAE respondents of South African companies with a large market capitalisation and reflects the following information:

- Current and future internal audit activities that are provided by/expected of the in-house and outsourced IAF.
- Comparison between this study and an international survey on the audit activities being performed by in-house and outsourced IAFs.
- Comparison between internal audit activities performed by the IAF and those that are performed by external parties.
- Importance of the various internal audit activities.
- Senior management rating of the value added by internal audit activities.
- Internal audit approaches followed by the IAF.
- Compliance with the *Standards*.

Internal audit activities

Figures 1 - 4 and Table 1 are based on identified activities that are performed by an IAF. Figure 1 contains the views of the CAE respondents regarding the current activities that the IAF of their particular company performs and on the activities that they anticipate that the IAF will perform in future.

The majority of the CAE respondents indicated that the activities of their IAF comprised operational/performance

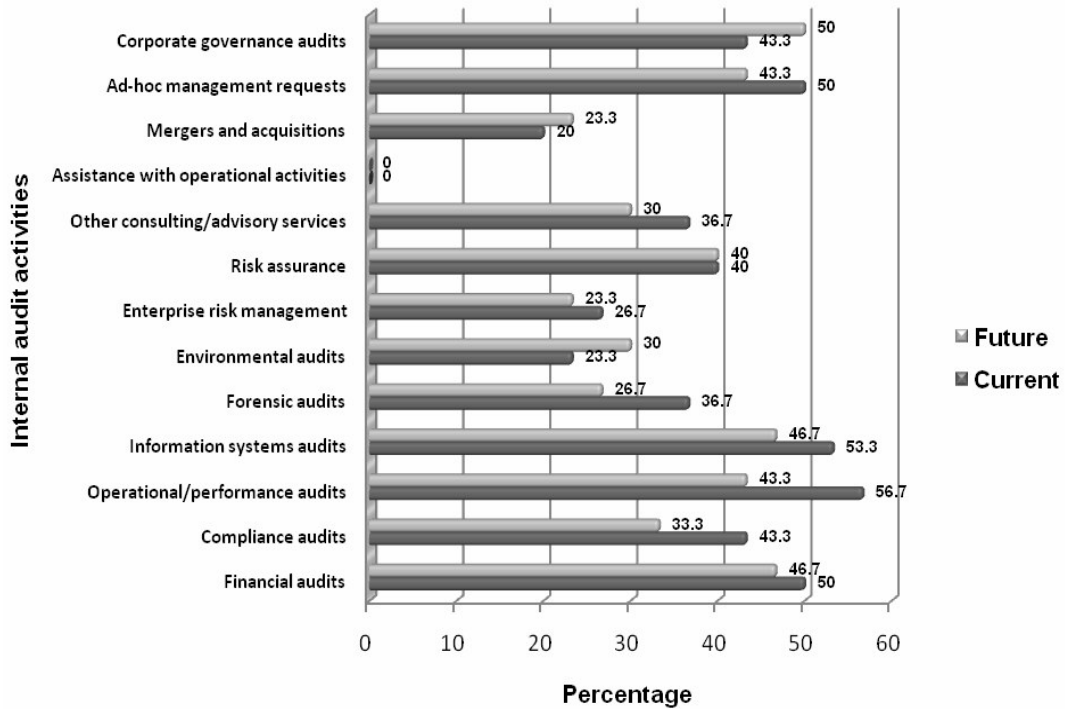


Figure 1. CAE – Internal audit activities currently performed/to be performed in future.

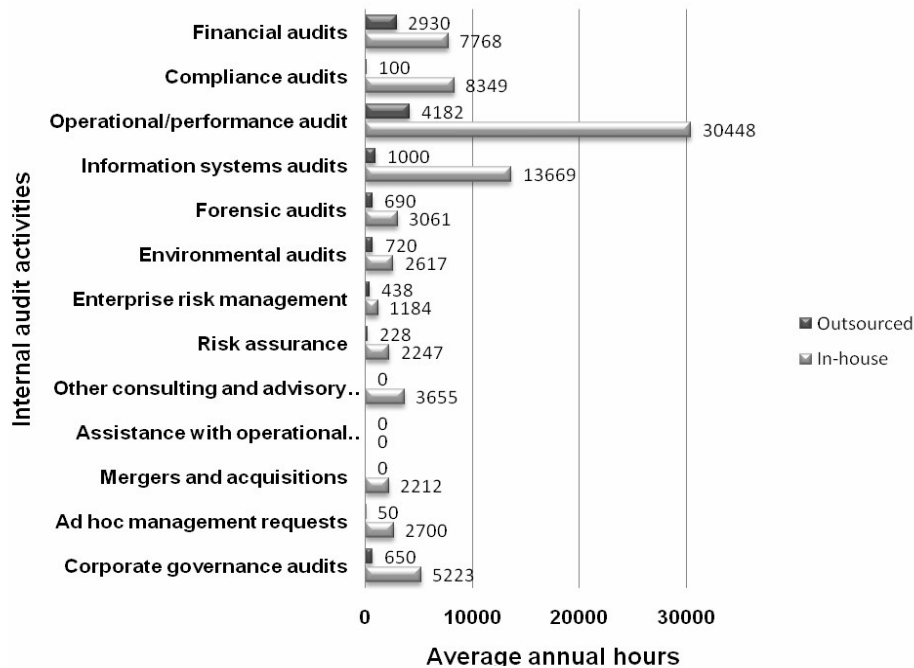


Figure 2. CAE – Total annual average time (in hours) allocated to current internal audit activities.

audits (56.7%), information systems audits (53.3%), financial audits (50.0%) and the execution of *ad hoc* management requests (50%). A lower level of consensus on the part of the CAE respondents regarding an IAF's

execution of compliance audits and corporate governance audits were noted. Other activities that an IAF performed include forensic audits, risk-assurance activities and the performing of other consulting or advisory

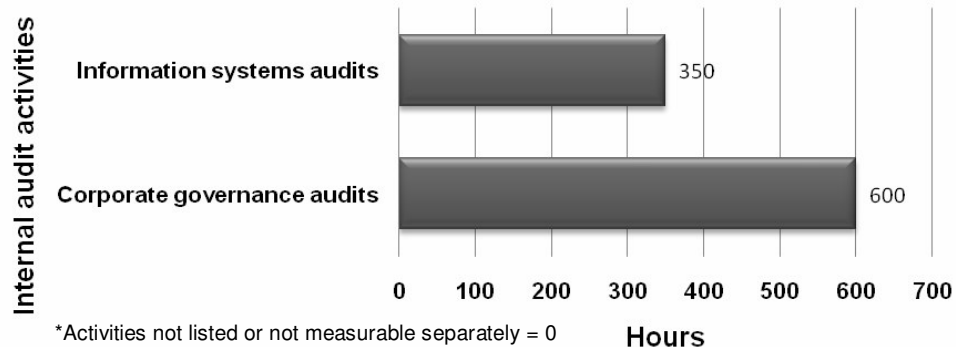


Figure 3. CAE – Average annual time (in hours) allocated to current internal audit activities* performed by another department in the company.

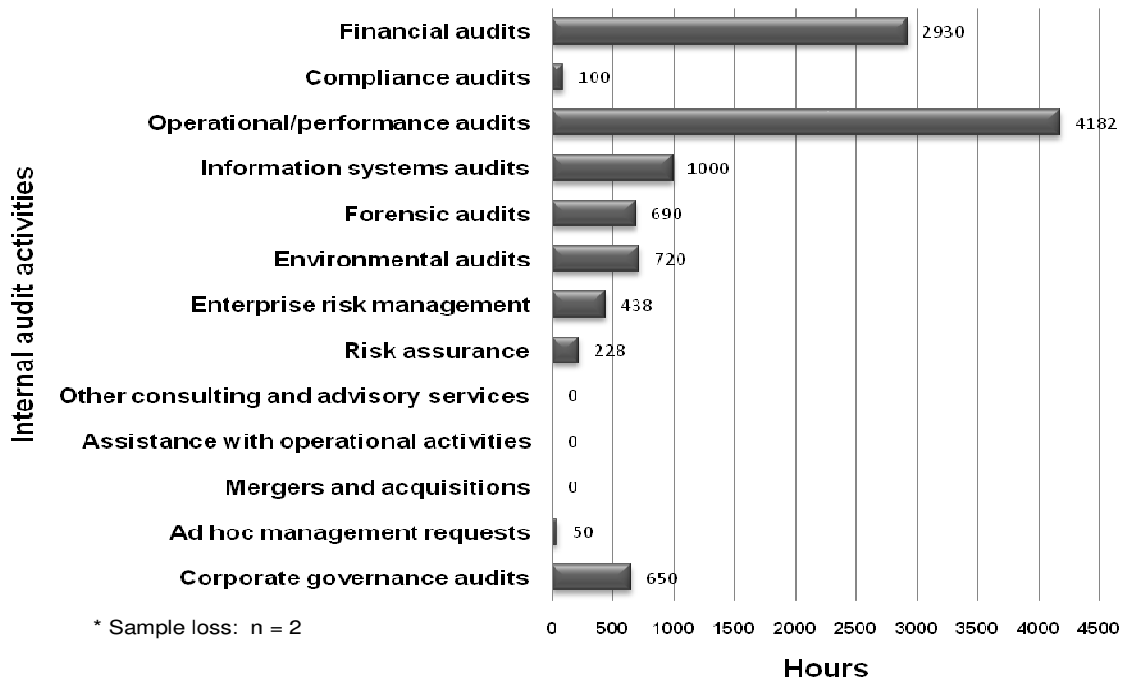


Figure 4. CAE – Average annual time (in hours) expected to be spent in future on internal audit activities.

Table 1. Type of audits that are performed by IAFs (CBOK, 2006 survey).

Type of audit	% of all respondents	% of South African respondents
Internal auditing	85.6	88.4
Operational audits	79.1	83.3
Investigations of fraud and irregularities	56.3	61.0
Financial auditing	56.0	63.5
Management effectiveness review / audit	48.5	57.0
Ethics audits	47.1	50.4
Information technology department assessment	45.4	46.8
Social sustainability audits	22.7	30.1
Quality / ISO audits	20.5	26.1

(IIARF, 2006).

services. The perceptions of the CAE respondents were that their IAFs were less involved in mergers and acquisitions, enterprise risk management and environmental audits. The CAE respondents perceived that none of their IAFs were involved in the provision of assistance with operational activities.

As the future involvement of IAFs in corporate governance audits was perceived to increase, corporate governance audits represent a potential area into which IAFs may expand their activities. Although corporate governance audits were perceived by the CAE respondents to be an important service that is performed by an IAF, the actual time spent (Figure 2) and estimated time to be spent (Figure 4) on corporate governance audits in future do not reflect the same perceived importance of this activity. This discrepancy could be attributed to the fact that a corporate governance audit is a high-level audit and that only the time of experienced/senior internal auditors was considered by respondents when indicating their perceptions.

Table 1 indicates the perceptions of all CBOK (2006) respondents (global IIA members) versus the perceptions of the South African respondents on the activities performed by IAFs.

Average time that is currently spent on internal audit activities by in-house and outsourced IAFs respectively

The data contained in Figure 2 indicates that the actual time spent on internal auditing activities, as perceived by the CAE respondents, corresponds with the above-mentioned views (Table 1) of the CBOK respondents globally on the type of activities provided by in-house IAFs and external providers (outsourced providers and other departments within the company). The internal audit activities in Figure 2 were identified by the iKUTU group as the scope of activities that are performed by the IAF.

The five activities on which most in-house hours were spent by IAFs are operational/performance audits (30448 h), information system audits (13669 h), compliance audits (8349 hours), financial audits (7768 h) and corporate governance audits (5223 h). Markedly less time was spent on mergers and acquisitions (2212 h), enterprise risk management (1184 h) and environmental audits (2617 h). This distribution of time spent on internal audit activities could be an indication of the level of priority and importance that IAFs allocated to the respective activities when preparing their annual internal audit plans.

The CAE respondents indicated that external parties were mainly involved in operational/performance audits (4182 h) and financial audits (2930 h). They spent less time on information systems audits (1000 h) and environmental audits (720 h) and the least time on forensic audits (690 h). It can therefore be deduced that, based on the perceptions of the CAE respondents, the main internal audit activities that were outsourced are

operational/performance audits and financial audits. However, the ratio of the time that outsourced IAFs spent on specialised audits (that is forensic audits and environmental audits) in relation to the total number of hours spent on audits, was much higher than for an in-house IAF. It therefore appears that an outsourced IAF played an important role in the provision of such specialised audits. These respondents also indicated that no internal auditing activities with regard to mergers and acquisitions or other consulting and advisory services were outsourced.

Figure 3 provides information on the number of hours spent per annum on internal audit activities by another department in the organisation of the CAEs.

According to the CAE respondents, other departments in their organisations are only involved in information system audits and corporate governance audits and based on the number of hours indicated by the CAE respondents, such involvement is of a limited nature.

Estimate of the future expectations of the average time spent on internal audit activities

The data contained in Figure 4 indicates the future expected estimated time to be spent on internal audit activities by IAFs, whether in-house or outsourced, as perceived by the CAE respondents.

It is clear from the above data that the emphasis of an IAF's activities was expected to remain compliance audits, operational/performance audits and information system audits. The importance of these activities was envisaged to be followed by financial audits. The CAE respondents expected that the time that IAFs will spend on compliance audits will increase tenfold in future. This expectation is a major potential indicator of the future appointment of internal audit staff.

It was expected that the involvement of external parties will primarily be in respect of operational/performance audits and financial audits. These expectations correspond with the status quo as perceived by the CAE respondents (Figure 4 - outsourced). External parties was expected to a lesser extent be involved in information systems audits, forensic audits and compliance audits.

Perceptions on the importance of specific IAF activities

The relative importance of seven core IAF activities identified by the iKUTU group is illustrated in Table 2.

These activities are assurance, system design and improvement, business improvement, forensic investigation; control self assessment, corporate governance and other consulting and advisory services. The CAE respondents were requested to rate these activities as being not important, of average importance or of significant importance.

The category of providing assurance was rated to be of

Table 2. CAE – Rating of the importance of IAF activities (Percentage of respondents).

IAF Activities	Not important	Average importance	Significant importance
Assurance	0	3.6%	96.4%
System design and improvement	14.3%	32.1%	53.6%
Business process improvement	7.1%	39.3%	53.6%
Forensic investigation	35.7%	28.6%	35.7%
Control self assessment	35.7%	25%	39.3%
Corporate governance	0	32.1%	67.9%
Other consulting and advisory services	35.7%	53.6%	10.7%

Table 3. CE – Rating of the value added by IAFs.

Activities	Perceived value added by IAFs (Mean)			
	Current		Expected	
	In-house	Outsourced	In-house	Outsourced
Forensic investigations	1.8	2.4	1.7	2.0
Mergers and acquisitions	2.5	3.1	2.3	2.6
Independent assurance	1.4	1.5	1.2	1.3
Reputation of company	1.9	2.5	1.4	2.4
Operational effectiveness	1.9	2.5	1.6	1.9
Control environment	1.4	1.6	1.2	1.4
Enterprise risk management	1.8	2.1	1.3	1.8
Corporate governance	1.5	2.4	1.4	2.1

significant importance by 96.4% of the CAE respondents. Corporate governance audits were regarded to be of significant importance by 67.9% of CAE respondents, while the remaining 32.1% of these respondents perceived it as being of average importance. The majority of CAE respondents (53.6%) rated the categories of system design and improvement as well as business process improvement to be of significant importance, while approximately a third of these respondents (32.1 and 35.7% respectively) perceived them to be of average importance. CAE respondents were not in agreement on the importance of forensic investigations and the control self assessments. Approximately one-third of the respondents (35.7% in both instances) perceived these two functions to be of significant importance, while the remaining respondents either perceived them to be of average importance or to be not important at all. The majority of CAE respondents (53.6%) perceived other consulting and advisory services to be of average importance, while 35.7% perceived these services to be not important. Only 10.7% of these respondents hold the opposite view by perceiving that this function is of significant importance.

The rating of senior management on the value added by internal audit activities

The CE respondents were requested to rate the value of

the current and future value added with respect to the internal audit activities (as identified by the iKUTU group) performed by both the in-house and outsourced IAF of their company. A scale of 1 to 4 was used where 1 = significant value added, 2 = moderate value added, 3 = limited value added and 4 = no value added.

The mean CE perception responses in Table 3 show that currently in-house IAFs, except for the rating for the mergers and acquisitions activity, were perceived to add moderate to significant value to their companies. Slightly higher ratings were indicated for future value added by the in-house IAFs. The CE ratings in respect of the outsourced IAFs (current and expected) were perceived lower for all the internal audit activities, ranging from moderate to limited value added. The high average ratings in respect of the value added by internal auditors to their companies as perceived by the CEs, is an indication that senior management of companies was satisfied with the extent of work that internal auditors perform and that their expectations were met.

Internal audit approaches followed by the IAF

Figure 5 provides information on the four different approaches that IAFs could follow. It illustrates the emphasis that IAFs place on these four approaches, as perceived by the CAE respondents.

The emphasis placed on various audit approaches was

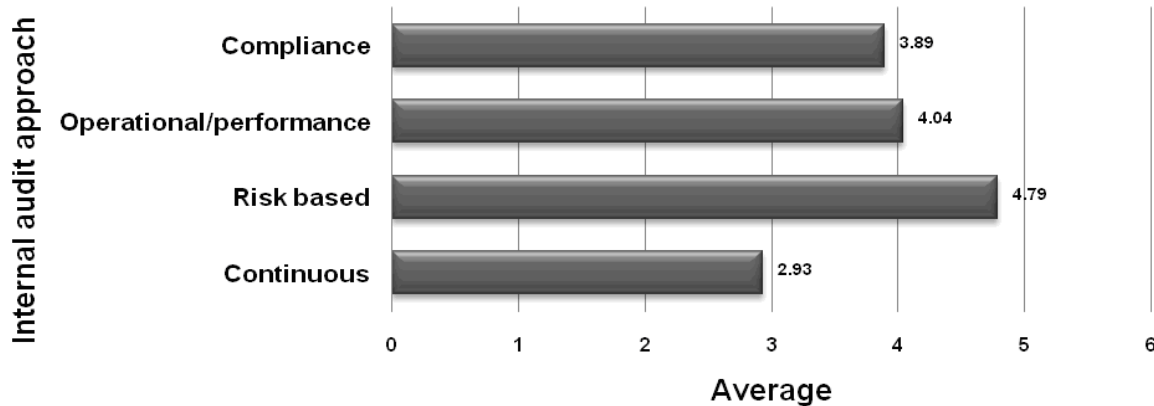


Figure 5. CAE – Emphasis placed on IAF approaches.

measured by means of a five-point Likert scale that ranges from 1 (not important) to 5 (extremely important). A response of '3' was regarded to indicate an importance that is higher than '2' and lower than '4' rather than being an indication of 'central tendency bias'.

Both the risk-based audit approach (mean = 4.8) and the operational/performance audit approach (mean = 4.0) were perceived by the CAE respondents to be extremely important. A compliance approach (mean = 3.9) was perceived to be very important, while a continuous approach obtained the lowest mean score and was emphasised the least (mean = 2.9) by the respondents. These findings may suggest that the CAE respondents have not yet been exposed to the continuous approach in auditing or that the practical application of such an approach has yet to be explored.

Compliance with the standards

Table 4 illustrates the views of the CAE respondents on compliance with some internal audit standards.

According to the perceptions of the CAE respondents, the majority of IAFs complied with the requirements in table 4, indicating a high level of compliance with the standards.

Conclusion

The results of this research provide insights in respect of the internal audit activities conducted by the IAFs of 30 large listed companies in South Africa. It was found that in-house and outsourced IAFs are involved in both assurance and consulting type engagement activities, but with a different perceived percentage of involvement in the different activities. Currently IAFs are perceived to be mostly involved with corporate governance audits, risk assurance audits, information systems audits, operational/performance audits, compliance audits and financial audits. The study found that CAEs were gene-

rally very positive about the activities that they perform and view themselves as a key role player in the enhancement of amongst others, corporate governance in their companies.

The results of the 2006 CBOK survey on the activities performed by IAFs revealed some similarity to the results of this study. Although the two studies did not investigate the same combination of internal audit activities, it is revealed that currently, except for typical internal audit engagements, operational audits are perceived to be performed the most in terms of hours. Fraud/forensic audits, financial audits and information systems audit are also in the top five activities/services on which internal auditors spend most of their time according to the perceptions of South African respondents of both studies. The number of average annual hours spent on the various activities by both in-house and outsourced IAFs is perceived to increase substantially in future when compared with the average annual hours currently spent on these activities. Although the respondents had to indicate their perceptions of current and expected future annual hours on the same list of activities used where they had to indicate which activities they currently perform, their responses to the two questions do not correspond. On the question to indicate the internal audit activities they currently perform or to be performed in future, the respondents indicated a slight decrease (ranging from 6 - 13.4%) in respect of compliance, operational/performance and information systems audits (Figures 3 and 4). Their perceptions in respect of the current and future hours spent on these activities, however, show increases ranging from 13 - 898% (compliance audits).

IAF respondents are regularly tasked with ad hoc management requests. The respondents indicated a high level of involvement in these activities which could be a hampering factor as it requires of the IAF to deviate from its annual audit plan and thus preventing the achievement of the internal audit objectives as set out in the annual audit plan. The ad hoc management requests are not provided for with regard to resources in the annual

Table 4. CAE - IAF compliance with the standards (Percentage of respondents).

Compliance factors	Yes
Do you have an internal audit methodology?	93.3%
Are internal audit engagements conducted in accordance with the International <i>Standards</i> for Professional Practice of Internal Auditing?	93.3%
Have you performed a quality self-assessment with independence validation in the last five years?	56.7%
Was an external quality assessment performed during the last five years?	63.3%

audit plan. A matter of concern, which requires further research, is the impact or effect of the high percentage of ad hoc management requests indicated by the CAE respondents on the annual internal audit plan which should be risk based (IIA, 2009a:28-29).

Based on the high perceived importance rating indicated by the respondents to assurance activities and the risk based internal audit approach it can be deduced that IAFs do perform their internal audit engagements according to the requirement of the Standards. The respondents also reported very high perception percentages (ranging from 63.3 - 93.3%) in respect of all four the compliance factors tested in this study. This deduction corresponds with the findings of the 2006 CBOK survey of the IIA (IIARF 2006). During the 2006 CBOK survey respondents, which consisted only of members of the IIA, indicated that 81.9% of all respondents globally and 93.9% of respondents from South Africa make use of the Standards in whole or in part when performing internal audit engagements. In respect of compliance with the Standards a high level of compliance (more than 80%) was perceived by all respondents of the CBOK (2006) survey. In South Africa only Standard 1300 (Quality Assessment and Improvement Programme) was perceived at a lower than 80% compliance rate which was not different to the perceptions of respondents globally (IIARF, 2006).

The analysis of the data gathered for this study indicates that the perceptions of CAEs are that they perform their audit activities according to what is expected of them by their governing body as well as by the senior management of their companies. The data further indicates that the senior management of these companies are satisfied with the internal audit activities performed by their IAFs. The internal audit profession, its clients and internal audit educators may take cognisance of the results from the study and utilise it in the planning of future internal audit activities and educational programmes respectively.

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