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Improving the Implementation of the Audit-General's Recommendations in South African State-Owned Enterprises¹

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Abstract

The objective of this research was to evaluate the implementation of the Auditor-General's recommendations regarding South African State-Owned Enterprises (SOEs). Emphasis was placed on two SOEs categorised as 'significant risk' entities according to the professional judgement of the AGSA. This study has been justified and necessitated by the need to understand the inefficiencies of SOEs regarding audit recommendations, particularly in significant risk SOEs such as Eskom and Transnet, and why the same problems are being repeatedly identified by the AGSA. The research methodology used in this study was qualitative, coupled with an extensive literature review and semi-structured interviews. Interviewees were selected using a purposive sampling method. The study found that factors that impact the implementation of audit recommendations include, a lack of available resources and time, the lack of audit recommendation implementation follow-ups, corruption within SOEs, the lack of consequences for transgressors, and unstable leadership, amongst others. The findings of the study revealed that there are recurring themes, such as governance and leadership issues, which can be explored by other researchers in future studies.

Keywords: State-Owned Enterprises; Audit recommendations; AGSA; Eskom; Transnet; Corruption; Lack of consequences; Unstable Leadership

1. Introduction and Literature Review

Good governance, sound financial decision making and accountability are important elements to achieve optimal performance (International Federation of Accountants (IFAC) 2013:14). These elements are echoed in the Constitution of South Africa and legislation such as the Public Finance Management Act 1 of 1999. Furthermore, governance, financial management and leadership are at the core of achieving organisational objectives. This study explores why these core areas are recurring themes in the Auditor-General's report on the national and provincial audit outcomes.

State-Owned Enterprises (SOEs) in South Africa play a critical role in driving infrastructure development in sectors that include energy (electricity and nuclear technology), transport (road,

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rail, ports, and air), telecommunications, and defence. The term SOE can be broadly defined as an entity that has been founded by the state and acts as its main shareholder, thereby exercising control over it (Black, Hashimzade and Myles 2012:1). SOEs were instrumental in rebuilding the South African economy after the apartheid government bankrupted South Africa before 1994 (Cheteni and Khamfula 2018:5). SOEs operate in the energy, transport, telecommunications, and defence sectors, amongst others, and should achieve dual objectives which include social and economic advancement (Presidential Review Committee 2011:30). In other words, some SOEs should provide a service that is sustainable, beneficial to the public, and profitable while competing with the private sector.

Furthermore, SOEs contribute to the economy through capital investment programmes and support services such as water, electricity, and roads to the formal and informal sectors in society. Simultaneously, the dominance of SOEs has contributed to low efficiency in the market. The abuse of power and a lack of effective oversight contribute to the low profit-making capability and large financial losses. According to the Auditor-General of South Africa (AGSA) (2017:42), poor governance, fraud claims, financial mismanagement, and financial sustainability issues have placed some SOEs in a negative spotlight in the media. Similarly, issues relating to poor governance, fraud, financial mismanagement, and difficulties regarding financial sustainability are some of the findings raised in the AGSA's general report on the national and provincial audit outcomes. The general report on the national and provincial audit outcomes is released on an annual basis by the AGSA. The report also contains findings relating to irregular, wasteful and fruitless expenditure, and performance management among others (Cheteni and Khamfula 2018:6).

The AGSA is the supreme audit institution of South Africa and is mandated by the Constitution of South Africa to audit all public entities, which include constitutional entities, national, provincial, municipalities, parliament, provincial legislatures, and any other entity required by provincial or national legislation (Public Audit Act 25 of 2004:6). However, the AGSA does not audit all SOEs as some SOEs are categorised as 'significant risk' entities. Significant risk entities are entities that require special audit attention, according to the professional judgement of the auditor (American Institute of Certified Public Accountants (AICPA) 2017:272).

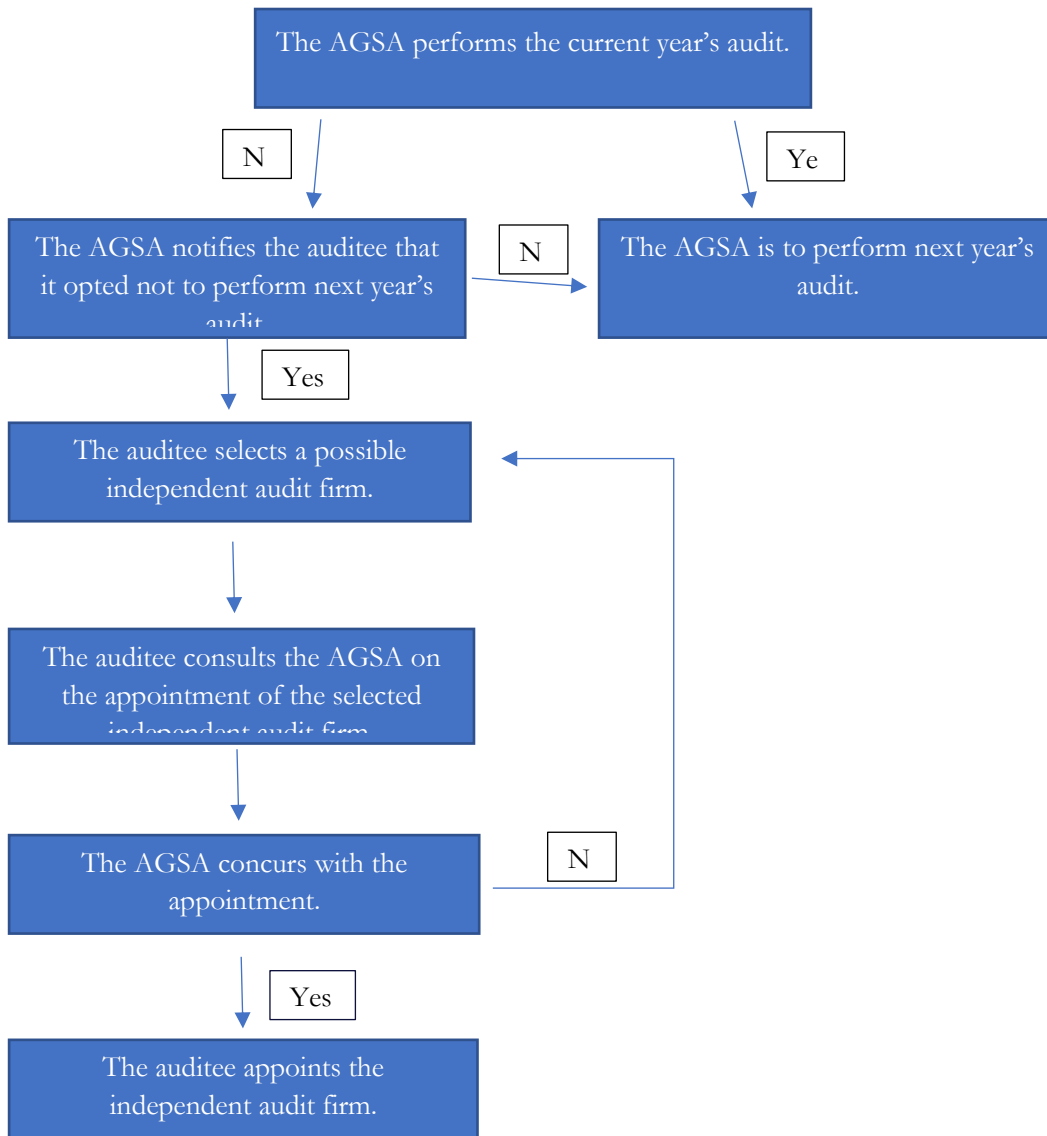
One of the factors that must be considered before classifying an SOE as a 'significant risk' entity is whether the management of the SOE has the power to override the board's decisions, this power is referred to as 'management override'. Management override is important because management is responsible for ensuring that internal controls are adequate (AICPA 2017:272). On the contrary, management can override internal controls and report that these controls are adequate. Therefore, such entities should be declared as 'significant risk' entities (International Auditing and Assurance Standards Board 2010:4). Furthermore, SOEs that are categorised as significant risk SOEs are audited by audit firms from the private sector under directives issued by the AGSA. These SOEs include Eskom Holdings SOC Limited (Eskom) and Transnet SOC Limited (Transnet), among others.

Significant risk SOEs appoint independent auditors in accordance with Section 90 of the Companies Act 71 of 2008. Section 90(1) provides that "each year at its annual general meeting, a public company or state-owned company must appoint an auditor" (Company Act 71 of 2008). Furthermore, the Public Audit Act in Section 25(1) provides for the appointment of an independent auditor if the AGSA has opted not to perform the audit of an SOE. The AGSA should communicate this decision to the auditee before the start of the auditee's financial year.

In other words, the AGSA should provide the auditee with confirmation on whether the AGSA will undertake the audit at least six months before the start of the auditee's financial year (Independent Regulatory Board for Auditors (IRBA) 2015:6).

The auditee should then search for an independent auditor and notify the AGSA about the independent auditor that the auditee is considering. The independent auditor that is considered by the auditee must be registered with the IRBA. The AGSA should then provide consent to the auditee to appoint the considered independent auditor. The AGSA's consent must be communicated no later than 14 calendar days or longer, dependent on the agreement with the auditee. In the event that the AGSA rejects the independent auditor considered by the auditee, the process should be restarted (IRBA 2015:6). Below is a schematic illustration of the appointment process.

Figure 1: A Schematic Illustration of the Appointment Process.



1: Schematic Illustration of the Auditor Appointment Process Source: IRBA (2015:12)

The board of directors, through its audit committee, is mandated by the committee charter (which details the role of the audit committee) to appoint an independent auditor. The AGSA establishes and maintains a close relationship with the independent auditor of the SOE. Such a close relationship between the independent auditor and the AGSA is necessitated by the need to establish a stronger oversight function in SOEs that are categorised as significant risk SOEs (AGSA 2017:42). The AGSA is also enabled to give input on how public sector audits should be carried out by independent auditors that emanate from the private sector. In other words, when an audit of a public sector entity is conducted by an independent auditor, the independent auditor must apply the audit methodology of the AGSA to ensure consistency in auditing public sector entities and reporting to parliament. Moreover, Section 28 of the Public Audit Act 25 of 2004 provides that the audit report of an independent auditor must reflect opinions

and statements regarding financial statements of the SOE, compliance to applicable legislation, and performance management. These audit types are explained below (Public Audit Act 25 of 2004:26).

1.1 Financial Statements

Financial statement audits are conducted to provide reasonable assurance that the financial information presented by the SOE is credible, reliable and a true and fair reflection of the financial position of the SOE (AGSA 2015:59). In addition, the opinion of the independent auditor should express whether the SOE complied with applicable financial frameworks and legislation for the reporting period (AGSA 2014:45).

1.2 Annual Performance Reports

Performance targets and objectives enable an auditee to measure and report on performance annually. In other words, it is the responsibility of the auditee to create specific targets and objectives that enable the performance targets to be achieved (AGSA 2015:86). The independent auditor should then audit whether the annual performance reports produced by the auditee provide pragmatic and reliable information for oversight bodies to assess the auditee's performance. The performance targets that are audited should be based on the auditee's mandate (AGSA 2014:51).

1.3 Compliance with Legislation

Furthermore, the independent auditor should conduct an audit on the compliance with key legislation relating to financial management and financial matters (AGSA 2015:95). During an audit on compliance with legislation, the independent audit should focus on the board's audit committee; the internal audit unit; management of expenditure (which includes irregular, fruitless and wasteful expenditure); the management of the budget; revenue management; consequence management; performance management; planning; supply chain management; the annual report and annual financial statements; conditional grants; compensation; human resource management; and transfer of duty. These focus areas usually highlight the bulk of the findings in public sector entities (AGSA 2014:57).

The annual publication of the general report on the national and provincial audit outcomes by the AGSA empowers oversight authorities to prioritise findings that relate to financial statements, performance management, and compliance with legislation. In addition, the AGSA does not only raise findings in its general report on the national and provincial audit outcomes, it also makes recommendations on how to deal with the findings raised. However, since the now deceased AGSA assumed office in December 2013, findings and recommendations were found to be repeated annually with each report on the national and provincial audit outcomes. In other words, SOEs do not prioritise the recommendations made by the AGSA, despite recommendations being clear and concise. Therefore, this study explores how the implementation of the Auditor-General's recommendations in South African SOEs can be improved with the focus being placed on two SOEs namely, Eskom and Transnet. This has been achieved by reviewing the general reports on the national and provincial audit outcomes, the integrated reports, and the financial statements of Eskom and Transnet respectively to diagnose why recommendations are repeated and how the implementation of the recommendations can be improved. Key among these, discussed below, include challenges with leadership, financial and performance reporting, and governance.

1.4 Challenges with Leadership

The Public Finance Management Act 1 of 1999 makes provisions for the role of the accounting officer. Section 38(1)(a)(i) provides that “it is the responsibility of the accounting officer to ensure that there are effective internal controls which include financial and risk management” (Public Finance Management Act 1 of 1999:36). In the context of an SOE, the board is the accounting authority, and the Chief Executive Officer (CEO) is the accounting officer that reports to the board. The board is composed of directors that serve on the executive management of the SOE and directors that are not part of the executive management of the SOE. The board appoints executives among itself through a nominations committee that nominates the executives of the SOE. These executive nominees should be approved and appointed by the executive authority, namely, the Minister of the Department of Public Enterprises. In other words, members of the upper echelon of the SOE, which includes the CEO and group executives, are appointed by the executive authority (PricewaterhouseCoopers, Institute of Directors in Southern Africa and Development Bank of Southern Africa 2011:2).

Collectively these layers (executives including the CEO, board of directors and the Minister) make up the leadership of an SOE. Leadership is a function which relates to a formal position within a particular organisation. Uwizeyimana (2020:30) argues that the leadership of an organisation should steer the organisation to develop in a better direction. This focus of this should be to improve financial management, performance management and compliance with legislation. However, the Presidential Review Committee (2011:110) and Kanyane and Sausi (2015:33) are of the view that an SOE board of directors is powerless in the appointment of the CEO. Accordingly, the principal-agent theory can be applied and is defined as follows: “A principal-agent relationship is a contract under which one or more persons (the principal) engage(s) another person (the agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent” (Mapanda 2018:46). On the contrary, the Minister (agent) with appointing powers in relation to the board and executive management of an SOE is a representative of the South African Government (principal). This highlights that the board and the executive management of the SOE operate in a political environment. Consequently, there is undue political interference in the functioning of the SOE (Organisation for Economic Co-operation and Development (OECD) 2005:14).

Political patronage is one of the factors that hamper the implementation of the AGSA audit recommendations in SOEs. Due to political patronage, the leadership structure of an SOE largely comprises political appointees as the Minister is responsible for firstly satisfying the political requirements of his/her political party, and secondly, pursuing the best interest of the SOE. According to Principle 2.14 of the King III, the board must always act in the best interests of the company (Institute of Directors in South Africa (IODSA) 2009:31). The board is accountable to the Minister and therefore, may be compromised as their appointment is influenced by politicians (Kamal 2010:214).

1.5 Challenges with Financial Reporting and Performance

It is the responsibility of the accounting officer to make sure that financial and administrative controls are in place to ensure that there is proper record keeping and an audit trail. The AGSA reported in 2015 that SOEs continue to rely on auditors to identify errors on the financial statements to obtain an unqualified audit opinion (AGSA 2015:62). Omissions and errors should be identified by the Chief Financial Officer (CFO) before signing off on financial

statements to be audited. The reviewing and approval processes should be strengthened to ensure that financial statements do not have any inaccuracies. Relying on independent auditors to identify corrections on financial statements places strain on legislated timelines, resulting in an increase in audit fees (AGSA 2015:62).

In addition, inadequate consequences for poor performance result in findings relating to supply chain management. Leaders and officials that do not expedite their duties should be dealt with through performance management processes. The failure to hold leaders and officials within SOEs accountable creates the perception that flouting legislated processes and procedures are tolerated. There are weaknesses in enforcing the consequence management policies, especially when it concerns senior management. There is a lack of consequences for transgressors, in particular to Eskom and Transnet, as the annual financial statements for both SOEs between 2014 and 2018 show that there is possible irregular, fruitless and wasteful expenditure coupled with financial misconduct and (AGSA 2015:62).

1.6 Challenges with Governance

Effective oversight is among the key challenges that impede the ability of SOEs to administer good governance. Oversight is not a function that can be executed in isolation, each role player or assurance provider within the SOE is responsible for ensuring that effective oversight can be administered. In other words, there are levels within each SOE that provide assurance which includes line management that provides assurance and reports on the full scope of controls and risk within the SOEs (Transnet 2015:44). The second level of assurance providers includes the internal auditors (can be SOE employees or externally appointed) who provide input on the risks that are faced by the SOE. The third line of defence is the independent auditors that cannot be influenced by the SOE management and are independent of the SOE. The fourth line of defence is the independent oversight parliamentary committees, such as the Standing Committee on Public Accounts (SCOPA), amongst others (Transnet 2015:44).

Each assurance provider should ensure that there is an action plan for the assurance provider that reports upward. For example, the internal auditor should create an action plan to ensure that the line manager focuses on the risks identified and deals with the previous year's audit report findings to avoid repeat findings. However, challenges arise when action plans are not in place as action plans deal with inadequate internal controls before findings arise (AGSA 2015:103-104). Additional challenges that impede good governance include key leadership vacancies and slow recruitment processes. On average, skilled and competent senior leadership at SOEs are retained for at least 40 months, or until the private sector poaches these leaders and offers more lucrative remuneration packages. Therefore, retention of competent leaders within SOEs is a challenge, as SOEs cannot compete with the remuneration packages offered by the private sector (AGSA 2015:103-104).

2 Research Methodology

This study used a qualitative research approach due to the opportunity this approach presents to gain deeper insights into the topic at hand. Some of the characteristics in qualitative research include an emphasis on the process rather than the final outcome or product (De Vos 2001:240).

Data was collected through semi-structured interviews using an open-ended questionnaire.

Semi-structured interviews allow the researcher to pose questions to participants in order to understand a process or phenomena through the views, beliefs, and opinions of the interviewee. It also allows the researcher to pose follow-up questions to gain a deeper understanding of the topic. In addition, interviews provide an opportunity for the researcher to interpret and draw meaning and understanding from what participants communicate when they answer specific questions (Kotane 2016:46).

The researcher conducted interviews with key stakeholders including a high-ranking representative from the independent auditor (Sizwe Ntsaluba Gobodo Grant Thornton (SNG-GT)), two oversight auditors from the AGSA, personnel from Eskom and Transnet, and a member who served on the Presidential Review Committee on State-Owned Enterprises. The purposive sampling approach was used to select the interviewees. Purposive sampling, simply put, means that the researcher deliberately selected interviewees due to certain qualities they possess (Tongco 2007:1). These qualities include the formal position of an interviewee within the hierarchy of an organisation that is relevant to the study, such as the AGSA, SNG-GT, Eskom, and Transnet, and the experience level of the interviewee within his/her industry and profession.

The respondents were presented with the same questionnaire to ensure that responses are valid. Thematic analysis was used to analyse the respondents' opinions to highlight various themes.

Consent forms were submitted to respondents prior to the interviews commencing. The consent forms guaranteed the anonymity and confidentiality of the participants. In addition, the study used documents that are available to the public.

The study found five areas that have a direct impact on the implementation of the audit recommendations. These include: a lack of availability relating to resources and time; the lack of audit recommendation implementation follow-ups; corruption within SOEs; the lack of consequences for transgressors; and unstable leadership. The section below provides an analysis of these findings.

3. Analysis of the findings relating to factors impacting the implementation of the recommendations made by the independent auditors and the AGSA

This study found that several factors impact the implementation of the recommendations made by the independent auditors and the AGSA to improve internal controls and achieve clean audits. These can be categorised into recurring themes in this study namely; leadership, financial and performance management, and governance. Firstly, there is a lack of availability relating to resources and time. Hodge, Subramaniam and Steward (2009:157) postulate that large funds and sufficient time are required to implement some audit recommendations. Human resources was shown to be among the biggest challenges faced by SOEs to carry out recommendations made by the independent auditors and the AGSA. The recommendations are made on behalf of the independent auditors and the AGSA, as the recommendations are discussed and agreed on between the AGSA and the independent auditor. The independent auditor then presents the auditee with the recommendations. Despite clear recommendations made by the independent auditor and the AGSA, inadequately skilled staff and/or a lack of staff hinder the implementation of audit recommendations. The training of new staff, coupled with contracting external skills, also places strain on financial resources and the recruitment processes can be time consuming (Transnet 2018:64).

Secondly, there is a lack of audit recommendation implementation follow-ups. The responsibility to follow up on audit recommendations should not only sit with the SOE as the preparer of the financial statements. However, the auditor should also create recommendations that can be acted upon easily. This highlights the quality of the auditor (Setyaningrum, Gani, Martani, Kuntadi 2013:90). The quality of the auditor can be measured through experience, education, training, and motivation. Empirical test results show that there is a positive relation between the following up on audit recommendations and the quality of an auditor. In other words, the higher the quality of the auditor, the easier it will be for auditees to implement audit recommendations as these recommendations are likely to be easier to act upon (Setyaningrum, Gani, Martani, Kuntadi 2013:90).

Thirdly, corruption within SOEs negatively impacts the implementation of audit recommendations as resources need to be reprioritised to deal with corruption and the impact that corruption has on SOEs. This is because millions of rands are lost and spent to try and curb corruption. Corruption “is a practice that can lead to the degeneration, even disintegration and debasement of social life” (Philip 1997:436). Due to the size of Eskom and Transnet, corruption can be widespread and the corrupted can become more efficient and more sophisticated than the authorities responsible for eliminating corruption. Corruption also requires a network of complicit individuals, and these networks can operate undetected within SOEs of this size for long periods of time. Between 2014 and 2018 Eskom and Transnet recorded over 200 cases, each relating to corruption and unethical conduct (Eskom 2016a:56; Transnet 2018:99).

The fourth factor that impacts the implementation of audit recommendations is the lack of consequences for transgressors that fail to comply with audit recommendations. The AGSA (2014:65) argues that “a less tolerant approach should be taken by all parties, including those charged with governance and oversight (executives, portfolio committees, public accounts committees, audit committees, and accounting officers), which will result in accountability being enforced and consequences for those who intentionally fail to comply with legislation”. In other words, the AGSA is of the view that audit recommendations will remain without action due to the perception that there are no consequences for not implementing audit recommendations.

The fifth and final factor for the purpose of this study that hinders the implementation of audit recommendations is unstable leadership. Eskom and Transnet have been dealing with this challenge for decades without success. For example, between 2014 and 2018, Eskom and Transnet each had three Chairpersons of their respective boards, two and nine Group Chief Executive Officers respectively and three Group Financial Directors each. This inconsistency relating to leadership enables discontinuity. In addition, political intervention is a contributing factor to unstable leadership and as a result, a lapse in governance of these SOEs (Transnet 2014:3; Transnet 2015:204; Transnet 2016:153; Transnet 2017:126; Transnet 2018:144; Eskom 2014a:66-67; Eskom 2015a:114; Eskom 2016a:136-137; Eskom 2017a:120-121; and Eskom 2018:134-135).

4 Recommendations

This section will provide recommendations to assist in improving the implementation of audit recommendations within SOEs.

4.1 Recommendations for Leadership

The AGSA (2015:23) states that “leadership needs to pay particular attention to effective governance structures and committee charters, stable leadership, adequate oversight of financial, compliance and performance reporting, adequate oversight of cash flow forecasts, an effective organisational structure, adequate systems of internal control that ensure credible monthly financial reporting (AGSA 2014:71), an effective and appropriate human resource training plan, an up-to-date policy register, action plans that are tracked and time frames that are met, a comprehensive and appropriate information technology strategy and accountability for non-performance”. In addition, leadership should adopt a culture of good governance and ethical business practices and place the interest of the SOE before any self-interest or political goals. This will assist in improving the implementation of audit recommendations with the SOE (AGSA 2018:125).

4.2 Recommendations for Financial and Performance Management

According to the Public Finance Management Act 1 of 1999 (1999:39) in Section 40 and 45, financial and administrative controls should encompass the following:

- “proper record keeping;
- entrench internal control disciplines;
- implement processes to monitor compliance; and
- implement effective financial systems and an appropriately capacitated finance function” (AGSA 2015:23).

In other words, performance and financial reporting should be supported through accurate and timely record keeping which should be enforced by management. For instance, financial transactions that have been captured should be reviewed and reconciled monthly. All areas that impact the financial and performance reporting should have a document trail to rectify any errors or omissions to achieve clean audits (AGSA 2014:72). The performance of staff should be monitored and evaluated with the aim of increasing productivity, as opposed to using performance management as a punitive measure that would reduce staff morale. However, during performance management evaluations, low performing personnel should be directed to undertake additional training to upskill in areas that are lacking (AGSA 2014:72).

4.3 Recommendations for Governance

The board and senior management of the SOE should interact with the audit committee and internal auditors to determine the root causes of audit findings and direct resources to resolve the root causes of audit recommendations, as opposed to only remedying the audit recommendations. Tangible action plans to deal with the root causes of internal control deficiencies should be created by the audit committee, internal auditors, senior management and the line managers across various departments to improve the overall control environment (AGSA 2018:118).

5 Conclusion

This study focused on improving the implementation of the AGSA audit recommendations in South African SOEs, and in particular Eskom and Transnet. SOEs were defined as entities owned by government. These SOEs drive development within the country and provide critical infrastructure such as electricity and roads. The AGSA is an independent Constitutional entity responsible for conducting the audit of public sector entities. However, the AGSA can opt not

to conduct the audit of a public sector entity. On the other hand, the AGSA does not audit entities such as Eskom and Transnet as it has categorised these SOEs as significant risk SOEs. These SOEs that are categorised as significant risk SOEs are audited by independent auditors under the auspices of the AGSA. The independent auditors should utilise the AGSA audit methodology to conduct the audit of these SOEs. The methodology of the AGSA includes an audit on the financial statements, annual performance reports and compliance with legislation. During these audits, findings arise that relate to leadership, financial reporting and performance, and governance. In addition, this study followed a qualitative research methodology and utilised the case study research method. Furthermore, five factors that impact the implementation of the recommendations made by the independent auditors and the AGSA were discussed. These five factors include a lack of availability relating to resources and time, a lack of audit recommendation implementation follow ups, corruption, the lack of consequences, and unstable leadership. The study concluded with recommendations on leadership, financial reporting and performance, and governance.

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