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The value of public sector audit: Literature and history

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ABSTRACT

This paper explores the value of financial statement auditing in the public sector. The study applies theory about auditing from the private sector as well as the public sector to explore ways in which public sector auditing can be expected to be valuable. It shows that there are a number of complementary explanations that can be applied to examine the value of public audit, including agency, signaling, insurance, management control, governance and confirmation explanations. The evidence from research and history is generally consistent with the agency and management control explanations. There is some support for the signaling and insurance explanations, while research evidence suggests that governance has differing impact in the public sector compared to the private. The confirmation hypothesis is also potentially relevant. Reviewing the history of the development of public sector auditing functions shows that at least some developments were consistent with explanations such as agency theory and management control. Auditing in the public sector is an area where more research is valuable. The paper concludes with a discussion of issues for further investigation.

1. Introduction

Public sector auditing is a large area of auditing practice that is complex and comparatively unexplored. The purpose of this investigation is to examine the function and purpose of auditing, especially in the public sector, and to review ways in which it adds value. The investigation summarizes evidence that public sector auditing adds value, and develops suggestions about how its benefits might be increased. It also develops issues for further research. This paper has been developed from a project that conducted independent research and reported on it to the Controller and Auditor-General of New Zealand. As a result, it refers to New Zealand examples on occasion, but these are expected to be relevant to other Western democracies.¹

Public sector auditing has not been as widely examined as it should. According to [Banker, Cooper, and Potter \(1992, p. 508\)](#) “researchers in accounting have not been responsive to the problems and opportunities associated with developments in government accounting,” and this comment is still relevant. Nevertheless the literature includes many valuable studies ([Baber 1983](#); [Blume & Voigt 2011](#); [Brusca, Caperchione, Cohen, & Manes Rossi, 2015](#)). The existing research can be divided into two streams, the “alternative” or “contextual” and the mainstream ([Broadbent & Guthrie, 2008](#)). We provide a literature review of the alternative research. We then review the body of literature examining the reasons why auditing is useful ([Abdel-khalik, 1993](#); [Chow, 1982](#); [Hay et al., 2014](#); [Wallace, 1980](#)). This auditing literature was primarily developed to examine private sector auditing, but can also be relevant to the public sector (e.g., [Evans & Patton, 1987](#)), and is related to the mainstream public sector literature. We examine this literature and its applicability to research about the value of public sector auditing, developing six explanations for the value of auditing. In many

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¹ New Zealand is often cited as an exemplar of public sector management and reform (e.g., [Jacobs, 1998](#); [Pallo, 2003](#)).

cases, public sector auditors have a responsibility for value for money auditing as well as for financial statement auditing, and we examine the issues regarding value for money auditing as well. We then review the historical development of public sector auditing to address why the institutions are constituted in the way that they are.

This review is timely because the environment of public auditing is changing, with greater access to public information through the internet now being widespread (O'Leary 2015), but declining interest in traditional news media outlets, and a change within news media towards more opinion pieces and reduced straight news coverage (Liebes & Kampf, 2009; Walton, 2010). Therefore, while the outcomes of public audits could be more readily available now than in the past, there may be less opportunity for the public to be informed about them through the news media.

In addition, this review is intended to be helpful to Supreme Audit Institutions (SAIs), and in understanding SAIs. SAIs are national entities responsible for auditing government activities. They vary among countries,² with three main categories (the Westminster model, the Napoleonic model and the Board system) (Dye & Stapenhurst, 1998; Stapenhurst & Titsworth, 2001). The "Westminster model" is used in many English-speaking countries, most of which have historic links to the Westminster system of Parliamentary government.³ In the Westminster model, the SAI is headed by an Auditor-General who is supported by staff in the Office of the Auditor-General (Dye & Stapenhurst, 1998).⁴ SAIs have agreed to follow the International Standards for Supreme Audit Institutions, one of which (ISSAI 12) (International Organization of Supreme Audit Institutions, 2013) requires SAIs to communicate with stakeholders to ensure understanding of the SAI's audit work and results, and a periodic assessment of whether stakeholders believe the SAI is communicating effectively (International Organization of Supreme Audit Institutions, 2013, p. 9). In order to conduct that assessment, it will be useful to consider the ways in which audits add value.

The objective of the paper is to use a literature review based on widely-used explanations for the value of auditing in general, together with a review of the historic development of the function of the Auditor-General, to obtain evidence about the value of public audit, and to develop suggestions for further research. Reviews of public sector accounting research show that there are two divergent bodies of research, described as alternative (or contextual) and mainstream. The contextual research has been more widely discussed in review papers, and is examined first. The mainstream explanations for the value of auditing that are applied are well-established in the auditing research literature. The explanations are often examined in the context of private sector auditing, but have also been applied in the public sector (e.g., Wallace, 1980). Choosing these explanations allows exploration of the public sector setting using a range of theories that complement each other; these include some that have been extensively developed. The theories help to develop recommendations and can be used to compare private sector and public sector auditing. The explanations are: an agency role; an information role; an insurance role; a management control role; a governance role; and a confirmation role. The issues considered are therefore the extent to which each of these explanations is consistent with the evidence about the public sector, and ways in which the research can be developed further. The paper shows that the first five explanations are consistent with observations, although further research will be worthwhile; the sixth explanation, confirmation, is potentially useful but has not previously been explored. We also trace the history of the public auditing function and examine its development in the light of the explanations for the value of public auditing.

The previous literature and the explanations for the demand for auditing are presented next, followed by a review of the historical development of public sector auditing. The reason for choosing this order is to present the more fundamental theory first so that the historic developments can be viewed in the context of theory. The review takes account of the changing environment and aims to indicate ways to increase the value of public sector auditing, and to highlight research opportunities.

2. Public sector auditing research in previous literature

There is a growing body of public sector accounting literature, which concentrates on management accounting and other accounting issues, although it does include some auditing studies. It is notable that there is a dichotomy between two main groups of research papers, those in the US and those in other countries (Goddard, 2010, p. 76). Several notable reviews of the literature concentrate on other research approaches, which they describe as "alternative" (Broadbent & Guthrie, 2008) as "contextual" (Broadbent & Unerman, 2011) or "interpretive" (Goddard, 2010) in contrast to the mainstream or positive research. The alternative approaches frequently use qualitative research whereas the mainstream approaches are more likely to be quantitative (Goddard, 2010).

The reviews of the alternative research in public sector accounting observe that there are a wide range of theoretical approaches used, including many studies that do not use theory. The most widely used approaches being neo-institutional theory and agency theory (Jacobs, 2012). There are calls for theoretical "promiscuity" (Jacobs, 2012, p. 19) although this suggestion was criticized for risking "mindless eclecticism" (Modell, 2013, p. 104). Jacobs (2016, pp.469, 479) observes that there is a perceived need for more and deeper theorisation.

The previous reviews are frequently based on a selection of journals which publish a particular type of research, and cover a broad range of accounting issues. They do not include an extensive discussion of auditing. However, some of the auditing research using agency theory is not inconsistent with agency theory as used in mainstream research (Jacobs, 2012; Johnsen, Meklin, Oulasvirta, &

² An early comparison of European and North American auditing is provided by Normanton (1966).

³ The Westminster system is the model of Parliamentary government of the United Kingdom and widely used in countries that had been under the influence of the British Empire (Galligan & Brenton, 2015; Rhodes, Wanna, & Weller, 2009; University of Cambridge, 2013).

⁴ The Napoleonic system is used in many French-speaking countries and within Europe, comprising a Court of Audit with judges and legal staff. The Board model has similarities to the Westminster system, but a panel (or Board) replaces the single Auditor-General. This paper focuses specifically on the Westminster model.

Vakkuri, 2004). In this body of research, there is sometimes seen to be a clash between different forms of accountability (individualised or economic versus social or political). Agency models are seen as concentrating excessively on some relationships, especially hierarchical relationships, at the cost of social accountability. Other research uses theories less likely to be found in mainstream auditing such as governmentality based on Foucault's work (Jacobs, 2012, p. 11).⁵ 3. Power's thesis of the "Audit Society" (Power, 2003) and related works by Power are noted as an example of "the closest thing to theory indigenous in the accounting literature" (Jacobs, 2012, p. 18).⁶ Another area of conceptual innovation is the changes to public sector management, accounting and auditing that commenced in the 1980s and that are known as the New Public Management. This is another area where Jacobs (2016) argues that more theorization is needed.

The public sector research that can already be drawn upon often describes itself as outside the mainstream. There is a schism between the mainstream and alternative models, and Goddard (2010, p. 85) exhorts researchers to combine the different approaches. In that spirit, we argue that there is a lot to be gained in understanding public sector research by applying the mainstream models to examine the value of public auditing. We make a step in this direction in the next section.

3. Explanations for the value of auditing in previous literature

Explanations for the function and value of auditing were developed to explain why auditing exists in settings without regulation, especially by Wallace (1980) and Chow (1982), along with some more recent contributions. They are relevant to explaining why auditing might be valued in settings where audits are compulsory for statutory or other reasons. They explain why it is in the interests of managers to engage auditors, and in some circumstances, to arrange to be provided with more auditing services than the minimum. In addition, the economic explanations for auditing help to explain auditing's strong position. Even in settings where there have been audit failures and auditing scandals for many years, such as the United States, auditing is in high demand, and the response to audit failures is generally to require more auditing, not less (Elliott 1994).

3.1. The agency (or monitoring) explanation

Under the agency explanation, auditing is valuable because it reduces agency costs. Wallace (1980, pp. 12–13) explains that agency relationships apply where one party, the principal, delegates authority, especially control over resources to another, the agent. An example of these relationships is between a company owner and a manager, but they also apply at several levels in the public sector. When agency relationships apply, there are costs in monitoring. Agents might be self-interested and spend money for their own benefit; or might shirk their duties; or might be diligent but misguided. If nothing is done to avoid these possibilities, then the principal will be less inclined to enter into this relationship. The principal will spend less; or even avoid entering into the transactions altogether, reducing the scope of the agents' activities or putting them out of work entirely. Agents have the incentive to prevent that from happening by arranging to reduce the costs of monitoring. The agent might appoint an auditor to report on the financial statements in order to give the principal more confidence and reduce costs. This expected development applies especially when there is one agent (a manager or chief executive) and multiple principals (such as shareholders, or Cabinet, Parliament and voters). It is worthwhile from the manager's point of view to provide auditing as a form of bonding of the manager, or monitoring on behalf of the shareholders (Chow, 1982). There is historical evidence that audits were sometimes arranged voluntarily in just this way before there was legislation requiring them (Chow, 1982; Wallace, 1980).

Thus, audits exist because of "price protection". Shareholders (or other stakeholders) might discount the information they receive, and pay a lower price for shares than the financial fundamentals would justify, because they know some managers in some situations might have an incentive to provide misleading information (Chow, 1982; Pincus et al., 1989). A partner in the US firm of KPMG wrote that "auditing adds tremendous value" (Elliott, 1994, p. 74). Elliott estimated that audits reduce the cost of capital substantially. Elliott (1994, p. 74) suggested a company without an audit might have to pay 1% to 3% more for capital, by which he meant that "for a company with \$10 billion in capital, the comparable annual savings would be \$100 million to \$300 million!". Empirical studies suggest that this amount is overstated, although a smaller effect is present.

Previous empirical studies provide evidence that financial reporting, auditing and other institutional arrangements that add credibility to financial reporting have reducing agency costs as part of their function. In the private sector, voluntary disclosure, voluntary auditing and voluntary formation of audit committees are associated with variables representing higher agency costs such as greater size, higher leverage or lower managerial ownership (Simunic, 2014, p. 36). Research in the private sector provides evidence that Big N audit firms, which are perceived to provide higher quality, charge higher fees (Simunic, 2014, p. 36). This finding provides evidence that managers value higher quality audits.

Agency theory is applicable to the public sector (Jensen & Meckling, 1976, p. 309) and has been used to explain issues related to financial reporting and auditing in previous public sector studies (Baber, 1983; Bradbury & Scott, 2015; Jensen, 2005). "An agency problem exists in local government because politicians are the elected agents of the electorate," according to Kurtenbach & Roberts (1994, p. 221).

An earlier paper (Streim, 1994) examined research that applies the agency and signaling explanations in the public sector.

⁵ Another approach is to use Moore's framework of public value (Cordery & Hay, 2018; Moore, 2013)

⁶ Power's analysis has been taken up in other disciplines including anthropology (Shore & Wright, 2015). These applications do not present a very complimentary view of the value of 'audit culture'.

Explaining agency relationships in the public sector is more complex than in the private sector as there are several levels of relationship (Streim, 1994). According to Streim (1994, p. 179) there are at least three main sets of principal-agent relationships, between electorate as principal and legislature as agent, between legislature as principal and government as agent, and between government as principal and bureaucracy as agent. The principal-agent model allows a reinterpretation of the ‘traditional’ problem of administrative accountability, namely that of the institutional mechanisms that allow elected politicians to hold bureaucrats accountable. Moe (1984, p. 765) states that:

“Democratic politics are easily viewed in principal-agent terms. Citizens are principals, politicians are their agents. Politicians are principals, bureaucrats are their agents. The whole of politics is therefore structured by a chain of principal-agent relationships, from citizen to politician to bureaucratic subordinate and on down the hierarchy to the lowest-level bureaucrats who actually deliver services to citizens” (Moe, 1984, p. 765).

The agency explanation applies in the public sector because citizens are in the position of principals who have entrusted assets to managers as agents. The agency relationships in the public sector are more complicated than in the private sector, according to Streim (1994), because, first, there is an agency relationship between voters (as principals) and politicians (as agents); but voters cannot observe the actions of legislators without cost. The potential gain to any voter is too low to make this worthwhile (‘rational ignorance’). News media can provide information to voters, but this is not as useful as one might expect, because they will tend to report only the most sensational information (Streim 1994, p. 179).

A second agency relationship is between government and Parliament. The government in Parliamentary democracies is usually required to report in detail to Parliament on its budget and expenditure. Auditing is “inevitable” to prevent the existence of “government from biased or manipulated data” (Streim, 1994, p. 182).

There is a third agency relationship between government and public servants. There is a conflict of interest between “chief bureaucrats”, who have incentives for larger budgets, and ministers, who prefer to eliminate any budgetary slack. In addition, the bureaucrats have access to more information (Streim, 1994, pp. 182/183). There could be similar agency relationships between the “chief bureaucrat” of an entity and his or her subordinates, but these are part of another explanation, management control (discussed below).

Hay (2001, 2003), following examples such as (Streim 1994, p. 178), applies a principal-agent model to the New Zealand public sector as a whole. He provides references showing that accountability can be linked to the extent of decentralization of an activity (Hay, 2001), and that the extent of decentralization is related to the knowledge transfer costs and extent of dependence associated with a public sector activity (Hay, 2003). The different organizational forms in the public sector⁷ are variations on principal-agent relationships and the variations can be explained by differences in the nature of the activities carried out by the various organizations and their varying levels of importance.

The auditors themselves are a party to yet another agency relationship, since the principal who appoints the auditor will not know whether or not the auditor is performing the level of service agreed upon (Streim 1994, p. 178). To overcome this problem, some form of inspection of the auditor is required. The extent to which SAIs are subject to an independent inspection process is a potential research issue.

Financial reporting by government bodies is based on economic incentives, according to (Zimmerman, 1977, p.108). As a result, he argues, their financial reporting systems can be explained, as well as the reasons why it had not been reformed despite calls for change (Baber, 1983, p. 215). Baber (1983) argues that political competition increases the incentives for monitoring in the public sector, and specifically for auditing. He suggests that monitoring takes place as part of a process of contracting between interest groups and political candidates. Competition requires political ‘entrepreneurs’ to supply monitoring so that they will be able to demonstrate to interest groups that they have kept their pre-election promises. If there is less competition from alternative candidates, then there is less need for monitoring (Baber, 1983, p. 215). He tests the relation between political competition variables (a political competition index and the number of state legislators from the dominant party, controlled for population, debt, number of state legislators and salaries of state employees) and the audit budgets of states in the USA. He finds positive correlations between state audit budgets and measures of political competition (Baber, 1983, p. 226). Baber concludes that his evidence implies that political competition increases the incentives of public officials to audit the disposition of public resources (Baber, 1983, p. 213). Baber, Brooks, and Ricks (1987) examine the relations between audit fees and political competition, among other factors, for county governments in North Carolina. They find some evidence that there are statistically significant associations between greater political competition and more auditing. Evans and Patton (1987) compare agency and signaling explanations. Their signaling explanation is discussed below. Blume & Voigt (2011, p. 226) examines the level of agency costs in a population of US cities. Cities that have high levels of agency costs due to voters or lenders tend to appoint higher quality auditors; those with lower agency costs are more likely to use internal auditors.

There are studies in the public sector that use an agency model to assess what difference a Supreme Audit Institution makes. Blume and Voigt (2011) assess the economic effects of differences in organizational design of SAIs on a cross-country basis among 40 countries. They develop measures of the mandate of the SAI (financial auditing or performance auditing, public reporting), its independence, and institutional environment. Independence includes a measure of financial independence (the resources allocated to auditing measured by number of SAI staff in relation to the country’s population), and institutional environment including whether the SAI uses the Napoleonic or court system as opposed to the alternatives of the Westminster system or the board system. Control

⁷ Such as State-owned Enterprises, Government Departments, local government and crown entities in this example of New Zealand.

variables are included for GDP, trade, civil liberties, proportion of the population over 65, ethnolinguistic fractionalization, and the protestant religion. There are very few significant results. The differences among SAIs do not seem to have any effect on the dependent variables selected. The only exception is that countries using the Napoleonic system or court model of SAI are associated with greater corruption (Blume and Voigt p. 215). Blume and Voigt (2011, p. 226) note that their study is the first to analyze the effects of the organizational set-up of SAIs on a cross-country basis. They also suggest that a better measure of “factual independence” of an SAI would be desirable (compared to their measure, the number of employees in proportion to inhabitants) (Blume & Voigt, 2011, p. 226).

A related explanation is investigated by Kido, Petacchi, & Weber (2012, p. 446) who examine the extent to which gubernatorial elections in US states are associated with their accounting choices. Their results show that state governments use discretion to manipulate accounting numbers in an election year; but they are less likely to when they have an independent auditor (Kido et al., 2012, p. 454). An independent auditor is defined as meaning elected rather than appointed (Schelker, 2013, p. 295).

Schelker (2013) examines a public sector setting (US states) in order to contribute to a private sector auditing issue, that of whether auditor appointments should be rotated periodically (Schelker 2013, p. 276). He argues that “the fundamental agency problem shareholders face is essentially similar to the one voters face in a democracy” (Schelker 2013, p. 283). He then examines bond ratings for states of the USA and whether they are related to variables concerned with state auditors, when other measures are controlled for. They find bond ratings are positively related to the length of appointment term for the state auditor and to whether he or she has a CPA qualification, but not to the length of time the auditor has been in office or to whether they are elected versus appointed by the legislature (Schelker, 2013, p. 295).

Rodríguez Bolívar et al. (2013, p. 560) examine the agency model as applied to disclosure of public sector financial information, using a meta-analysis. They investigate five factors that constitute the common basis of existing models in research literature (Rodríguez Bolívar et al., 2013, p. 560). The variables that determine disclosure of public financial transparency are: financial condition; inter-governmental subsidies received; political competition; size; and wealth of citizens. They find that all five are significantly associated with transparency.⁸

Other recent studies include Botica Redmayne, Bradbury, and Cahan (2010) who argue that the political visibility of a public sector company creates a need for more justification by auditors, and show that greater political visibility is associated with more audit hours and higher audit fees. Bradbury and Scott (2015) show that accounting performance by local councils in New Zealand is associated with greater voter turnout and with whether local councilors are re-elected.

Summarizing this section, an important part of the value of financial statement auditing is reducing agency costs. If there were no audits, some business transactions would not occur, as principals would not enter into arrangements where their resources were entrusted to agents. In the public sector, if there were no audits, fewer resources would be available to government agencies. There is evidence about this explanation for the value of auditing in both the private sector and the public sector. The agency explanation is the economic explanation for accounting and auditing that is most widely researched, but there is still scope to apply it to understanding the auditing arrangements for the public sector in various jurisdictions.

3.2. The signaling explanation

Managers of private sector companies have better information about the value and quality of their business than outside investors do (“information asymmetry”). If managers make statements in the financial report that claim that their business is a better investment than others, they can add credibility and increase the value of their business by engaging a higher quality auditor (Titman & Trueman, 1986). This is the signaling (or information) explanation for the value of auditing (Titman & Trueman, 1986, p. 160). An entrepreneur who has more favorable private information about their firm will choose a higher quality auditor; investors are able to infer the entrepreneur’s information from the choice of auditor; and entrepreneurs with less favorable private information are not able to mimic this signal (Titman & Trueman, 1986, p. 160).

Better information leads to better decisions by managers and outsiders. The presence of an auditor allows outside parties such as investors to give more credibility to the financial statements. Wallace (1987) suggests that signaling could carry over to the non-profit sector, and asks, “Do non-profit entities that issue audited financial statements receive greater contributions?” Hay and Davis (2004) applied the signaling explanation to New Zealand incorporated societies. They found evidence consistent with the proposition that management of non-profit society can use the appointment of a high-quality auditor as a signal of superior performance in order to attract greater contributions. Similarly, Kitching (2009, p. 510) found that charities benefit from the choice of a higher quality auditor as a mechanism to signal the credibility of financial information. Gore (2004, p. 24) shows that municipal governments have incentives to disclose more financial information in response to incentives provided by the bond market.

For the government as whole, signaling could be applicable. The government has an interest in convincing the public that when it makes statements about public expenditure or public assets that it is credible, and that when it makes decisions it is using reliable information. Ensuring that there is a credible independent audit body helps it to do so. In practice, in most Western countries, government information is accepted, for example there is generally little dispute over accounting figures announced by the government such as the annual surplus or deficit.

Research on signaling has been applied to public sector accounting and auditing in studies like Evans and Patton (1987) and

⁸ They also consider neo-institutional theory and legitimacy theory, both of which predict that entities will respond to external pressures so that similar measures can be expected to be associated with transparency.

Sanders and Allen (1993) which examine whether public sector entities that apply for certification of their financial statements do so in accordance with the incentives for signaling. The signaling or information explanation is sometimes considered to be complementary to the agency explanation (although Evans & Patton, 1987, argue that there is more support for signaling than agency). There is a body of research on the US municipal bond market and the impact on it of accounting, and in some cases auditing, reviewed by Ingram, Raman, and Wilson (1987) and Ingram et al. (1987, p. 121). The evidence shows that government financial reports provide timely and relevant information to the financial markets (Reck, Wilson, Gotlob, & Lawrence, 2004, p. 1) and that accounting information is significantly associated with yields (Bastida, Guillaón, & Benito, 2014). A recent study extended research on signaling and municipal bonds to Spain (Bastida et al., 2014) and found that the municipal financial situation influences interest rates.

Signaling appeared relevant when managers of state-owned enterprises in New Zealand argued that they should be able to appoint audit firms who were members of the then Big 8 to give them greater credibility in financial markets (Green & Singleton, 2009; Pallot, 2003). Local government entities also borrow on international markets. Signaling theory might also apply in other public sector settings where stakeholders have an interest in credible information.

If there was no auditing, managers would have less ability to attract investors or to convince other users that their financial statements are credible. Signaling is another way in which managers benefit from having an audit of the information that they provide to outsiders. The existence of performance audits and inquiries is also another way for the government to signal to outsiders that it is a reliable manager of resources. Whether governments which are able to provide signals by better auditing are more credible and attract more investment or pay lower interest rates is a potential question for examination.

3.3. The insurance (or ‘deep pockets’) explanation

It is sometimes suggested that stakeholders may demand audits as a way of increasing the chance of recovering certain types of losses. The auditor provides a “target” that they might be able to take legal action against to recover any investment losses from, because the auditor has resources (“deep pockets”) (Chow, 1982).

As a result, auditors can find themselves facing costly litigation even when they have little responsibility for the losses. This explanation might apply indirectly in the public sector as a means of recovering reputations – auditors sometimes take the blame for public sector failures. It may be that the value of auditors is in providing an independent scapegoat, which insulates the elected politicians and other parts of the public sector from the consequences of financial failings. Wallace (1980) suggests that an audit in the public sector can provide “political insurance” whereby governments can use auditors as a scapegoat for failings by public sector managers. This argument can apply if, for example, the Auditor-General accepts some responsibility for a failure in management control over expenditure.⁹

In addition there have been several cases, including one recent case, where legal action for monetary losses has been brought against the Auditor-General of New Zealand.¹⁰ There were earlier such cases in 1949 and in the 1980s (Green & Singleton, 2009, pp. 82 and 145).

Insurance over financial statements or decisions by managers is not the intended purpose of auditing in the public sector, but auditing may nevertheless be valued for that reason. The examples referred to above show that the insurance explanation is plausible, but it would still be useful to investigate further. There is considerable overlap between the agency, signaling and insurance explanations and the three explanations frequently work together.

3.4. The management control explanation

Management control for the benefit of internal management is another explanation for auditing. Some business owners purchase voluntary audits as part of a control system for loss of control within their organization. A public sector equivalent to this explanation could apply, when executive government or high-level bureaucrats demand an audit to assist with the control over a government entity.

Abdel-khalik (1993) showed that private companies are more likely to voluntarily choose to have an audit when they have more layers of hierarchy or are larger. He argues that auditing helps top management to control complex organizations. A similar explanation can apply in the public sector: while the audit of a public sector entity is not primarily intended to provide information for the entity’s top management, nevertheless the audit provides them with some assurance about what is going on in the remote corners of the entity.

The history of public sector auditing (Funnell, 1994) provides evidence that management control was an early function of public sector auditing. Auditing also includes recommendations to management to help with systems. Managers might also benefit from help with reporting, perhaps, and from improving management reputation.

Hay (2003) examines how the extent of decentralization in New Zealand public expenditure is associated with the type of

⁹ In 2013, the Auditor-General of New Zealand apologised for defects in the audit of Kaipara District Council. Lyn Provost said: “an independent reviewer identified problems with some of the audit work carried out by Audit New Zealand. For that, I apologise unreservedly to each and every one of you” (Radio New Zealand News, 2013).

¹⁰ The Kaipara District Council subsequently took legal action against the Auditor-General, making the insurance explanation even more salient. The *Northern Advocate* reported: “It’s understood the case against Ms Provost may relate to her earlier admission of poor work done by the Audit Office when scrutinising the council books” (Ali, 2015).

knowledge generated by the activity and how transferable it is, and how dependent the rest of the public sector is on that activity. This explanation is based on [Jensen and Meckling \(1995\)](#).

The management control explanation for auditing is that auditing is also valuable in helping managers to control large, complex entities. It might be expected that the extent of internal and external audit would be greater for activities that are more decentralized. This question is also worthy of further investigation.

3.5. Governance

Auditing is closely associated with corporate governance and so it can be of value for organizations whose stakeholders are subject to higher risk. Other governance mechanisms are also used to reduce risk, such as internal audits, audit committees and independent directors. The interaction of these various mechanisms can sometimes have complex results, because the audit committee members and external directors become stakeholders themselves, and also seek to minimize risk. As a result, the demand for auditing, or for higher-quality auditing, can be higher when there are other governance mechanisms in place. [Bédard & Compennolle \(2014, pp. 256–259\)](#) review research showing that stronger audit committees are associated with choosing higher quality auditors, greater control over the risk of non-audit services and increased negotiating power for auditors compared to managers. There is a tendency for governance to be enhanced in recent times in both the private and public sectors and this is usually associated with greater demand for auditing. Better corporate governance is not a substitute for auditing, but is complementary to it.

Governance of private sector and public sector entities has been developed extensively in recent decades. In some countries, especially the United Kingdom, there have been frequent reports and recommendations for enhancements to corporate governance (on a comply-or-explain basis). The use of audit committees in the local government sector in the US is increasing according to [Matkin \(2010\)](#) and [Fitzgerald and Giroux \(2014\)](#). [Fitzgerald and Giroux \(2014\)](#) find that the extent to which local governments have audit committees is related to higher agency costs and also to the use of signaling mechanisms.

However, there is further evidence that corporate governance relationships work differently in the public sector. It may be that in public sector settings, governance mechanisms can substitute for each other, not act as complements. [Botica Redmayne et al. \(2011\)](#) find support for the explanations in previous research, so far as profit-oriented entities in the New Zealand public sector are concerned, but not for the remaining public sector entities. Their evidence shows that audit committees in the public sector were associated with higher audit fees for profit-oriented public sector entities, and lower audit fees for public benefit public sector entities ([Rich & Zhang, 2014](#)). A recent US study finds that audit committees in municipalities are associated with fewer internal control problems, but the presence of a financial expert on the audit committee makes no difference; and that audit committees which include one or more employees are more effective than those that are fully independent ([Rich & Zhang, 2014](#)).

Other elements of governance such as audit committees and internal auditors are also interrelated to auditing. [Jensen and Payne \(2003\)](#) find that municipalities in the US can substitute internal auditors for external auditing. Their results show that entities that do not have internal auditors tend to engage external auditors with greater levels of expertise. [Baber, Gore, Rich, & Zhang \(2013\)](#) shows that their ability to do this depends on the level of agency costs. Another recent public sector study shows that financial reporting quality is higher when municipalities have higher quality auditors and when they have audit committees; but lower when the elected local government is more entrenched ([Baber et al., 2013](#)).

The issue of the extent to which governance processes are associated with auditing in the public sector is worth further investigation. There are indications that the results in the public sector are different from those in the private sector, especially the issue of whether governance and auditing are complements or substitutes.

3.6. The confirmation hypothesis

Announcements by companies, such as profit announcements, contain information that has mostly been reflected already in share prices. This finding by [Ball and Brown \(1968, p. 176\)](#) has been well-documented. As a result, audited announcements of financial information usually do not add as much information as announcements of new, price-sensitive information ([Ball & Brown 1968, p. 176](#)). Under the confirmation hypothesis, announcements about past financial performance and position are still important, because they verify earlier unaudited announcements. [Ball, Jayaraman, and Shivakumar \(2012\)](#) suggest that “audited financial reporting and voluntary disclosure of managers’ private information are complementary mechanisms for communicating with investors, not substitutes” and that “Managers are encouraged to be more truthful when they are aware their disclosures of private information subsequently will be confirmed” ([Ball et al., 2012, p. 137](#)). This is the confirmation hypothesis. It suggests that while voluntary announcements of private information held by managers have market impact, they are complements to subsequent audit financial reports.¹¹ [Ball et al. \(2012, p. 137\)](#) also argue that the impact of unaudited announcements is greater when managers have committed more resources to independent audit by paying higher audit fees.

[Ball et al. \(2012\)](#) found evidence to support the confirmation hypothesis by showing that companies which make more frequent and more specific management forecast announcements also commit to greater auditing. Nevertheless, very little evidence to support

¹¹ Earlier, [Sorter \(1979, p. 4\)](#) argued that “you cannot expect that financial statements provided fresh news at point of impact”. . “They provide a mechanism which allows users to interpret new information as it comes along. By identifying certain crucial relationships, it allows users to interpret new sales data when it comes along in terms of what a change in sales means to Chrysler vs. General Motors. Statements allow users to determine the significance of a wage settlement. In addition, financial statements can be in used to validate alternate information sources and users’ predictions.”

the confirmation hypothesis has been provided as yet, and such evidence as exists is ambiguous. The confirmation hypothesis is plausible in understanding why auditing is important even when unaudited announcements are widely used and unaudited information often has more impact.

In the public sector, unaudited information is also often important. A paper by Hay (1994) based on interviews and reviews of public information found that there were few users of audited public sector external reports in New Zealand. A public sector parallel to the confirmation hypothesis might apply whereby unaudited information is accepted at face value, but a later audited financial report is needed to eventually confirm that the information was reliable. There is a useful research opportunity to investigate what announcements are made, and to what extent they are relied on because they are supported by subsequent audit announcements. In line with contemporary changes to the information environment, Reck and Wilson (2006) show that less use is now being made of financial report information by participants in the market for US municipal bonds, as more timely information is now being made available through sources of unaudited information, such as the borrowing entity's website.

3.7. Other explanations

Public benefits, externalities, public choice and other explanations are discussed in this section. Public sector (and private sector) auditing provides direct benefits to stakeholders or other parties, and externalities that could benefit the wider society. There are also incentives for auditing to be used in the political system as a result of other incentives, such as political gain. This section reviews these explanations for the value of auditing, and discusses research concerned with them.

Hay et al. (2014, p. 12) provide an explanation of auditing as a public good. In the private sector, many stakeholders benefit from audited financial information, even if they are not involved in hiring and compensating the auditor. As a consequence of auditing being a public good, there are free-riders who take advantage of it without paying for it. Since most stakeholders have little direct control over a company, there is a concern that too little auditing may be produced in spite of the natural demand for auditing. That results in sub-optimal demand for the purchase of audits, and for that reason auditing is often imposed by legislation (Doty, 2014). Legislators therefore impose auditing requirements for the benefit of the community (Doty, 2014).

Similarly, in the public sector, there are numerous parties who benefit from audits, but who are not in a position to negotiate an audit themselves. As well as stakeholders such as lenders or owners, these could include other affected parties such as employees or suppliers, or voters and interest groups which represent them. Legislation to require financial statement audits benefits these groups. Performance audits and inquiries have similar advantages.

Schelker and Eichenberger (2010) analyze the impact of auditors on fiscal policy at the Swiss local level and argue that auditors improve transparency and provide essential information on the impact of policy proposals on common pool resources, which leads to less wasteful spending. "Auditors who can evaluate and criticize policy proposals ex ante to policy decisions, significantly reduce the general tax burden and public expenditures." For a further example, Nagy (2012) argues that impact of an SAI can result in "lower governmental expenditures, more effective public finance management, increasing trust, transparency and accountability." The World Bank (2007) suggests that after accrual accounting was adopted in the public sector, financial reports became more important to management, and so the role of the auditor became more important too.

Auditing might also be imposed by regulation because it can have positive externalities. Better private sector auditing is believed to be associated with better economic performance. The World Bank frequently makes improving the auditing standards within a country part of its priorities in making recommendations, e.g., in Argentina (The World Bank, 2007). Rajan and Zingales (2001, p. 480) provide evidence that countries with better accounting have greater investment and more economic growth, and write: "a country intent on economic development should fix its financial plumbing." The World Bank (2001) states that it "supports SAIs and tries to strengthen them when working with developing countries." It states that conditions for successful SAIs are a supportive environment; clear mandate; independence; adequate funding, facilities and staff; sharing of knowledge and experience internationally; adherence to international standards, e.g., those of the International Organization of SAIs (INTOSAI). Public sector auditing could also provide direct or indirect benefits because it has positive externalities.

There is also evidence that good accounting and auditing in general are good for a country's economy. Kimbro (2002, p. 325) examines a model that links economic, cultural and information/monitoring variables to corruption in 61 countries. Inter alia, financial accounting systems are associated with low corruption. Kimbro (2002, p. 326) measures financial accounting by the CIFAR index of accounting standards (1995) (Center for International Financial Analysis and Research) and number of accountants per capita. Corruption is measured by Transparency International's Corruption Perceptions Index (the average for 1995-99) (Kimbro, 2002, p. 329).

"Public choice" explanations include an alternative set of views about regulation which is relevant to audit. These explanations consider the incentives of those who make the regulations. When there is a controversial audit failure that imposes hardship on the community, there might be an incentive for legislators to impose further regulation. Ball (2009, p. 289) argues that the Enron scandal was such an example, and that the subsequent changes to include independent regulation of auditors and new auditing requirements in the Sarbanes-Oxley Act was Congress's response. In private sector auditing, there appears to be a continuing cycle of increases in regulation in response to any problems that are seen as relating to auditing, and auditing has become much more highly regulated over the last 100 years. This lends credibility to the public choice explanation.

The incentives of the Auditor-General as a utility-maximizing bureaucrat can also be considered. Auditors-General as heads of the SAIs have resources to manage, and have influence. An Auditor-General might be expected to have incentives to maximize the resources under his or her control. Downs (1967) calls this "territoriality". There are examples of Auditors-General arguing strongly for resources and independence (Tyler in the 1980s, Macdonald in the 1990s, according to Green & Singleton, 2009). These cases

might represent territoriality, or alternatively they can be seen as the use of valuable professional knowledge by the Auditor-General.

Finally, there are a variety of other explanations for developments in public auditing. These include, for example, neo-institutional theory and a radical mentality that perceives accounting as potential constrainer of economic accountability. [Frumkin and Galaskiewicz \(2004\)](#) apply the framework of neo-institutional theory from [DiMaggio & Powell \(1983\)](#). They consider that the public sector is more subject to pressures for mimetic, coercive and normative isomorphism than the private sector. [Frumkin and Galaskiewicz \(2004, p. 285\)](#) quote [DiMaggio and Powell \(1983\)](#) suggesting that public sector entities are subject to: “(1) coercive isomorphism that stems from political influence and the need for legitimacy, (2) mimetic isomorphism resulting from standard responses to uncertainty, and (3) normative isomorphism associated with professionalization.” Public sector accounting and auditing could be expected to be similar to that in other similar countries as a result of these pressures, and to become more convergent. In addition, [Everett, Neu, and Rahaman \(2007\)](#) examine two contrasting ‘mentalities’ in anticorruption. The first, the orthodox mentality, “has us envision accounting’s involvement in the fight as part of a relatively unproblematic if not noble cause.” The second, portrays accounting as also being a potential constrainer of economic accountability and the achievement of the liberal republican dream.” Accounting, they appear to be suggesting, does little for the victims of corruption such as the global poor, women and indigenous people. Accounting is more associated with corporations that exploit these disadvantaged groups.

3.8. Value for money and other responsibilities of public sector audits

The responsibilities of an auditor in the public sector vary widely according to the jurisdiction that they operate in. In many cases there are responsibilities for value for money auditing (or performance or effectiveness auditing) as well as for expressing an opinion on the fairness of financial statements. The value of these types of audit is an area about which there are conflicting views ([Barrett, 2012](#)), for example because there are expectation gaps over what can be achieved. While many studies of value for money audits see them as useful, they are also seen as problematic, because they depend upon auditors using information that may be not reliable, on auditors knowing best practice and on auditors making value judgements about issues that are not captured by monetary values ([Lapsley & Pong, 2000, p. 563](#)).

In conducting value for money audits (and related work) auditors are providing a service which is intended to be valuable. It is seen as a useful and rational management tool by [Johnsen, Meklin, Oulasvirta, and Vakkuri \(2004\)](#) who compare local government value for money audits in Finland and Norway. It is valued for its contribution to performance and accountability ([Reichborn-Kjennerud, 2013](#)). [Morin \(2001\)](#) examined whether value for money audits result in long-term improvements, and examined the factors that contributed to audits that result in improvements ([Morin, 2001](#)).

Value for money auditing has been influenced by the New Public Management (NPM). It is described as one of many NPM reforms ([Guthrie & Parker, 1999](#)); or alternatively as an auditing technique that was superseded by NPM, but that nevertheless found a new role ([Jacobs, 1998, p. 357](#)). Criticisms of value for money auditing include its being drawn from a management consulting culture in audit ([Free et al., 2013, p. 441](#)) and as compromising the independence of auditors who strongly promote the performance-accountability framework ([Gendron, Cooper, & Townley, 2001, p. 306](#)).

The existing value for money auditing studies, which are within the alternative stream of research, rely mainly on qualitative research, and examine the circumstances in which auditors can or should provide value for money auditing, and when it is effective. They concentrate generally on the supply of value for money audits, rather than demand. Studies, for example, examine the perception of auditees, and whether auditors can stir Parliament’s interest in an issue. ([Morin, 2001](#)). An exception is the study comparing institutions in Finland and Norway by [Johnsen et al. \(2001\)](#). They use a framework of neo-institutional theory, and conclude that use of value for money auditing is influenced by differences in management and by mimetic isomorphism ([Johnsen et al., 2001, p. 595](#)). The demand for value for money auditing, and the circumstances in which it is likely to be of value has scope for research, too. Using the framework that this paper has set out in earlier sections, it could be useful to examine the explanations using agency explanation; signaling; insurance; management control; governance; and confirmation. Comparing different countries, and whether variations in these explanations for the demand for auditing is associated with the extent of value for money appears to have considerable potential.

3.9. Summary and review of theory and research

In summary, auditing provides direct benefits in itself, as well as positive externalities. These beneficial effects would not occur without auditing. Research on issues about auditing shows that it has benefits in both the private sector and the public sector. To a large extent, these benefits accrue to managers of the entities being audited. Audits give confidence to principals such as owners or funding sources to keep on funding the entity being audited. The agency relationships on the public sector are very rich and complex and their impact on auditing should be explored more. Particular questions for investigation that arise from the discussion above include whether more agency relationships are associated with more auditing activity; and the extent of inspection of the auditors. Audits send a positive signal to potential lenders and other investors. The cross-national study of the impact of SAIs by [Blume & Voigt \(2011\)](#) is not very conclusive, but it shows potential, and similar studies could examine signaling effects of SAIs on a cross-national basis. The insurance function of auditing in the public sector might be surprising, but it exists, partly as “political insurance” in the way proposed by e.g., [Blume and Voigt \(2011\)](#). There is little or no research on the insurance explanation in the public sector. Audits are beneficial in helping top management keep control of the organization that they are responsible for. The management control explanation fits well with the agency explanation, and research might be able to examine the two in relation to each other. Studies could examine whether a greater number of levels of hierarchy are associated with a greater extent of auditing. Auditors are also

increasingly important as part of corporate governance, and can be of benefit to the organization as a whole and to directors. Corporate governance is an area where the results of empirical research in the public sector have produced contrary results compared to those in the private sector, so that further investigation of this anomaly would be worthwhile. The confirmation hypothesis has potential, but is yet to be investigated. Overall the research appears to be moving from a more narrow focus on particular settings to broader comparative studies.

4. Evidence from history

Historical examinations of the role of accounting and auditing provide an overview of the evidence of the benefits of good auditing to a society or country as a whole. Looking more specifically at developments in the Westminster system of government, and in New Zealand particularly, shows how auditing has evolved as an important constitutional function. The Westminster system is the form of government in many English speaking countries including Canada and Australia, and was based on constitutional developments in England and later the United Kingdom (Dye & Stapenhurst, 1998). It is often but not always associated with the Westminster model of public sector auditing (Funnell, 2007). New Zealand is a straightforward example of a Westminster democracy with a Westminster model of public sector auditing that is well-regarded internationally. The explanations reviewed in the first part of this paper are also important in explaining the development of public sector auditing.

4.1. The history of public sector auditing in the Westminster system

Auditing in the public sector within the Westminster system developed roughly in line with the development of the need for management control and an agency relationship. Public sector auditing as it is currently known is old-established, dating from the 1860s. While it has ancient roots, in the Magna Carta (1215) and the Glorious Revolution (1688), auditing after those events was not a regularly-conducted, independent, professional function as it exists today. Independent public sector auditing dates from the 1860s (Funnell, 2007). The role of public sector auditing in Westminster systems continues to evolve, for example in New Zealand with legislation of 2001. Public sector auditing could be done differently, and in 1988 a New Zealand Parliamentary committee considered the issue of whether the public sector Audit Office could be replaced by private audit firms.

Auditing of public expenditure has existed for a long time, but early efforts appear to have been somewhat sketchy. Einzig (1959, p. 35) explains that Magna Carta established the principle of no taxation without consent of Parliament. He observes that committees for auditing various transactions were appointed by Parliament on several occasions, for example in 1340, “but there is no evidence that their labors produced worthwhile results” (Einzig, 1959, p. 117). Soll (2014) observes that the king’s personal revenue and expenditure were generally kept secret. King Edward III (ruled 1327-77) stated that “Kings do not render accounts except to God” (Roseveare, 1991, p. 15). Roseveare also observes that Parliamentary audit had been demanded in 1624, but “conspicuously failed to take root” (Ferguson, 2001, p. 52 of 1729). At this time the potential benefits to the executive government of auditing as a way to reduce agency costs, or for management control, do not appear to have been recognized. In addition, the relationship between Crown and Parliament had not yet developed into the kind of structure in which there was an agent in a principal-agent relationship who might perceive benefits from obtaining an audit.

Ferguson (2001, p.180 of 1046) notes that the consent of Parliament to taxation “was constitutionally secured by the ‘Glorious Revolution’ of 1688 which gave Parliament the exclusive right to raise new taxes and to audit government spending” and is supported by Dickson (1967). The Glorious Revolution established Parliament as principal in an agency relationship with regard to the executive government, and this was linked to an early development of public sector audit (North & Weingast, 1989, p. 817). North and Weingast (1989) explain that, “Shortly thereafter, Parliament gained the never-before-held right to audit how the government had expended its funds. Parliamentary veto over expenditures, combined with the right to monitor how the funds they had voted were spent, placed important constraints over the Crown” (Normanton 1966, p. 372). They also state that “controlling Crown behavior required the solving of financial problems as well as appropriate constraints on the Crown. So the Glorious Revolution also ushered in a fiscal revolution.” (North & Weingast, 1989, p. 816). However, Funnell (1994) shows that this function was rather constrained and perfunctory. Auditing in the public sector had now become possible, but still required further development.

Funnell (1994, p. 177) argues that before 1785, auditing of British public sector activities was very haphazard in coverage and timing, and was conducted on behalf of the executive for the purpose of detecting fraud. Prior to 1785, the Auditors of the Imprest were an ancient office, but an executive department, Treasury, controlled which accounts were audited and could overrule their decisions (Funnell 1994, p. 181). Funnell (1994, p. 182) states that the positions were regarded as something of a sinecure. To the extent that auditing was carried out, it concentrated on the function of management control.

From 1785–1832, audits became more widespread, but these audits were still not an independent state audit on behalf of Parliament. Audits were carried out for the executive, and intended to detect fraud and encourage honesty in dealings with government departments (Funnell, 1994, p. 177). This demand from auditing appears to be more consistent with the management control explanation for auditing. In the period 1832 to 1866, state audit on behalf of Parliament began to emerge, particularly after concerns (in 1831) about spending by the navy that had not been approved (Funnell, 1994, p. 185). Nevertheless, Treasury decided which departments were to be audited (Funnell, 1994, p. 187).

At that time in history, there was demand for independent auditing. “In the 1780s and subsequent decades Parliament became thoroughly conscious of its rights and responsibilities in the sphere of accountability and was pressing the Executive systematically for more facts and figures in respect of past expenditure” (Einzig, 1959, p. 174). Auditing appears to have been demanded by Parliament, rather than by executive government, that is by the principal and not by the agent. Subsequently, “by the middle of the

nineteenth century Parliament [in the UK] was in a position to exercise the powers of financial control that it gained through the Revolution of 1688” (Einzig, 1959, p. 130).

In 1866 the Exchequer and Audit Departments Act “converted the nominal control by Parliament into real control” (Einzig, 1959, p. 236). It compelled all departments to submit audited accounts to Parliament showing whether the moneys issued by Exchequer were actually spent in accordance with Parliamentary appropriations. It also included appointment of a Comptroller and Auditor-General who was “entirely independent of the Executive and entirely in the service of Parliament” (Einzig, 1959, p. 237). The [UK] *Exchequer and Audit Departments Act* established a modern state audit committed to appropriation audits on behalf of Parliament (Funnell, 1994, p. 177). Funnell observes (1994, p. 178 and 185) that in this period Parliament was comparatively strong with respect to the executive. It was “the golden age of responsible government” (Funnell, 1994, p. 185). Nevertheless, although the Controller and Auditor-General was independent, the influence of the auditors was limited, because Treasury remained in control of staffing and funding and sometimes did not provide sufficient resources (Funnell, 1994, p. 192). In addition, the person appointed as Auditor-General was generally a civil servant from the Treasury, and the Auditor-General was not expected to have audit expertise (Funnell, 1994, p. 190). Funnell (1994) concludes that reforms in the nineteenth century “created the illusion of an independent state auditor.” He says this because state audit had previously been under the control of Treasury, and still was to a large extent in fact; and because even if the Auditor-General in person was independent, the other members of the Auditor-General’s Office were not. Funnell (1994, p. 180) observes that “the state auditor working for Parliament and vaunted claims for his independence are very recent features of Westminster democracies”. The independent audit function is consistent with the agency and management control explanations for auditing, because there was no effective audit when there was little need for control; then as government grew larger, auditing as a management control was introduced; and subsequently, after an agency relationship developed, the audit became independent. At the time that independent auditing was established, Parliament, the principal, was in a relatively strong position. Normanton (1966) describes government auditing in the UK after that as “an audit on behalf of both the legislature and the executive, under the detailed direction of the latter” (Buchanan & Simpkins, 2001). Because there is a multiplicity of agency relationships (as discussed earlier in the paper) the audit function is required to deal with more than one of the agency relationships.

4.2. The development of public auditing in New Zealand

The Westminster system of government, with its approach to auditing, was exported to a large number of countries which were part of the British Empire. New Zealand provides an example of a country where public sector auditing is highly developed and where the extent of transparency is well-regarded internationally. The development of the New Zealand public sector was closely linked to that of the United Kingdom (UK). In early colonial days, there was an audit function like that of the UK at the time; later a more independent auditing function was imposed on the government at about the same time as it was developed in the UK (Green & Singleton, 2009, p. 11).

Responsible government by Parliament in 1856 was followed by increased audit responsibility, and a position of “auditor of the Public Accounts” to provide a check on the executive (Green & Singleton, 2009, p. 17). Subsequently, according to Premier Edward Stafford (1861), “We passed an Audit Act which gave to the legislature complete control over the public accounts; we built the Auditor of Public Accounts into a castle, from which he can effectually check the Executive with respect to its expenditure; and from which he cannot be removed by any Ministry, but by the Legislature only” (Green & Singleton, 2009, p. 11).¹² At this time, Parliament in New Zealand was in a strong position in comparison to the executive because political parties were yet to develop (Green & Singleton, 2009, p.11). This position was paralleled by the situation in the UK, where a strong public audit function was now developing and Funnell observes (1994, p. 178 and 185) that in this period [the UK] Parliament was comparatively strong with respect to the executive (Funnell, 1994, p. 185). The development of independent public sector auditing in New Zealand and the UK appears to be related to the agency explanation and Parliament being in a position to make demands for the executive to be accountable.

There was also evidence of the insurance explanation in 1949, when the Crown was sued after the Audit Office had delayed auditing the accounts of the New Plymouth Borough Council, and it was claimed that the delay allowed a fraud by the cashier to continue longer than it otherwise would have (Green & Singleton, 2009, p. 82). The Crown was required to pay the approximate amount stolen after the audit should have started (about a third of the total loss of £17,000) (Green & Singleton, 2009, p. 82).

Since then, public sector auditing has continued to develop. There was greater demand for change at the time of the public sector reforms of the 1980s. New Zealand was at the forefront of the worldwide New Public Management (NPM) reforms. NPM was a change in management style from earlier “progressive public administration (Hood 1995). In New Zealand, NPM set off conflict or competition between Treasury and Audit Office over the public sector (Jacobs, 1998).

“Treasury’s main objective was to create a more efficient public sector, it tended to emphasize the managerial chain of accountability with the relevant minister at the apex. Though the Audit Office also placed great store by efficiency, it persisted in seeing its main function as one of an external watchdog, with a duty to ensure the facts about the use of public resources were brought into the open’ (Green & Singleton, 2009, p. 128).

Treasury’s view tends to concentrate on one agency relationship, between managers and Cabinet; while the Audit Office is more

¹² New Zealand appears to have reached that stage earlier (1861) than Westminster did (1866). Green & Singleton note (2009, p. 26) that Auditor-General Fitzgerald (Controller and Auditor-General 1867-96) corresponded with British Prime Minister W.E. Gladstone.

likely to include the relationship of Cabinet to Parliament (Pallot, 2003). Both management control (via Treasury's demands) and agency (via Parliament) are evident.

In this era of reforms to public institutions, a variety of changes to the Audit Office were proposed. These included eliminating the office completely; or introducing greater competition; or enhancing the independence of the Auditor-General. In 1988, Parliament's Finance and Expenditure Committee commissioned a report on the Audit Office from Strategos Consulting group. The report provocatively questioned whether there was a need for an Audit Office, or whether the functions could be carried out by private auditors or by internal auditors (Green & Singleton, 2009, p. 130). The Auditor-General argued in response that "is recognized throughout the world that the only way Parliaments can assure the independence of the audit function is to employ a legislative auditor whose position and authority are both created and protected by statute" (Report of the Finance and Expenditure Committee on Vote Audit, 1988, p. 25). Eventually, new legislation (the Public Audit Act 2001) was passed – after a substantial delay. The 2001 audit legislation defines which entities are to be audited by the Auditor-General. The Auditor-General publishes the auditing standards they will use in a report to Parliament at three-yearly intervals (Green & Singleton, 2009, p. 153).

4.3. Review of the history of public audit

Reviewing the history of public sector auditing shows that it is a very old-established function, but also a living organism that continues to change. While it is old-established, it is not ancient, and it has undergone recent change. Reviewing the theoretical explanations for the existence of auditing in the context of history shows that the explanations are applicable, although to varying degrees. Public sector auditing is consistent with the agency theory explanation, although the explanation is made more complex by the existence of multiple agency relationships, and historically there has been stronger demand for auditing from the principal than from the agent. The signaling function of auditing is likely to be useful in creating confidence among investors. The insurance explanation for auditing has been relevant occasionally. Auditing to assist in management control has been very important in the development of public sector auditing, and it also appears to contribute to governance. The role of auditing in confirmation of previous unaudited announcements could be important, but has not been investigated.

5. Discussion and issues for further investigation

The literature review and the review of history show a number of themes. One of these is existence of multiple complementary explanations for why auditing is valuable. Agency relationships are particularly important in explaining the value of auditing, and these are more complicated in the public sector. Auditing for management control has always been important as well. Specific areas in which we suggest that further research will be productive include comparative studies of Supreme Audit Institutions and their impact; examination of changing governance practices in the public sector and their impact on auditing; more investigation of how and why institutions were created the way that they are; reconciliation of the differences between the two major areas of research, the alternative and the mainstream; and more extensive examination of the demand for value for money auditing.

We observe that it is not well-documented just how much public sector auditing varies among countries. In discussing issues with public sector auditors and researchers, we found that the full extent of variations among jurisdictions was often not appreciated. A research approach that would be productive is to examine the economic impact of the form of Supreme Audit Institution (as in, e.g., Blume & Voigt, 2011). This investigation could start with a more complete comparison of the different ways in which public sector auditing is practiced in different jurisdictions. These include the Westminster model, the court model, and the board model; SAIs that cover all of the public sector compared to those that cover only central federal government; or other approaches such as centralised appointment and contracting out of auditors. Further development of this approach could then proceed to examine why these variations exist, and what impact they have on public sector financial information, efficiency and effectiveness.

There is also scope for a closer historical examination of why and how public sector institutions were created as they are. This examination could also contribute to examining why and how particular structures are preferred and how effective they are.

As Goddard (2010) observes, there is a wide gulf between two approaches to research about accounting in the public sector, the alternative and the mainstream approaches. Goddard refers to them as "bunkers" and raises the risk of "groupthink." He suggests there are opportunities for the two areas to be brought together. We agree that reconciliation of the differences between the alternative and the mainstream approaches to research in public sector auditing is valuable. This pathway will allow theoretical models used in the mainstream and in private sector research to be used to understand the value of public auditing, in ways which we have suggested in the main body of our paper. This reconciliation can also allow for the alternative theories used in public sector research to inform private sector research.

We also suggest that there are opportunities for more extensive examination of the demand for value for money auditing. With some exceptions, the existing research on this topic has concentrated on the supply of value for money audits, and the issues that auditors face in doing so. Examining the reasons why this service might be in more demand in some settings than in others, and applying the explanations for the value of auditing that we have suggested will also be useful.

In the government sector, there has been a demand for auditing for a considerable period, but an independent audit function has tended to be imposed for agency or management control reasons. There has been a consistent pattern of contention over whether public audit is for management control (a view often espoused by Treasury) or in order to create a wider accountability to Parliament and other stakeholders (a view more likely to be promoted by auditors). In addition to the agency and management control explanations, signaling is likely to be relevant because governments raise finance; insurance is relevant, because the auditor is placing their reputation, and occasionally their assets at risk by being associated with a financial report; governance is increasingly relevant

to current developments; the confirmation explanation is likely to be relevant but this is as yet untested. Reviewing the body of previous research shows a number of ways in which public auditing is valuable and some questions for further investigation.

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