# Auditing Practices in Local Governments

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# Auditing Practices in Local Governments: An International Comparison

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INVESTOR IN PEOPLE

Laurence Ferry – *Dedicated to my wife Anchalee, daughters Dior and Eloise, mother Hazel and father Laurence*

Pasquale Ruggiero – *Dedicated to my wife Giuliana*

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Chapter 1

# The Why, Who and What of Public Sector Auditing

*Laurence Ferry, Pasquale Ruggiero and Henry Midgley*

**Abstract**

Public sector audit has grown in importance since the 1980s across the world. In this chapter, the authors outline the state of the current debate about public sector audit – including the role of the auditor, the purpose of audit, developments in the content of audit and the function of audit. The authors argue that these can be conceptualised through the literature of regulatory space. Drawing on the work of Ferry and Ahrens (2021), the authors set out categories which can be used to compare the ways in which different systems of local government audit can be compared and provide the justification for the intellectual approach taken by the rest of the volume.

*Keywords*: Theoretical framework; regulatory space; public sector audit; audit practices; accountability; local government

## 1.1. Introduction

Ideas such as 'audit explosion' and/or 'audit society' are taken for granted and perceived as referring to and framing a homogeneous realm (Power, 1994, 1997), but this explosion has generated the establishment of new institutions, practices, objects, subjects and in some cases a different idea of citizen and of their role. Furthermore, such reconfigurations of institutions and notions of citizenship have been accompanied, and indeed made possible, by the increasing 'accountingisation' and 'auditability' of things, irrespective of whether or not the models and practices have any meaning or any technical properties (Arrington, 2007). As stated by Hood (1995), public administration, especially in Nordic and Westminster countries, has experienced a process of reform aiming mainly at a greater

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responsibility and accountability of these organisations for their outputs and outcomes. Performance is to be reached through the adoption of 'explicit formal measurable standards and measures of performance and success' (p. 96).

Public spending and the related activities, carried out directly or indirectly by public administrations, account for a significant share of national gross domestic product and is often conceived as a critically important way for overcoming periods of economic and social crises (Prota & Grisorio, 2018). Nevertheless, public administrations are usually criticised as inefficient and ineffective giving rise to never ending calls for new processes of reform (Dunleavy & Hood, 1994; Hyndman & Lapsley, 2016). Most public resources are raised through taxation from citizens and businesses who require, for justifying their money going out, that public administrations provide worthwhile services without wasting financial resources. In this environment, accountability and assurance are key in the democratic process, with auditing attempting to fulfil this public interest role (Skærbæk & Christensen, 2015). As a consequence, auditing practices deserve research attention to develop knowledge about their functioning and indirectly contribute to increase public sector performance and democracy (Ferry & Midgley, 2021; Johnsen, 2019).

Despite its important role and the recurring call for more auditing (even if an increasing call for auditing itself could be understood as a failure of trust in the market-based society or in the central steering institutions of society – see Power, 2000), public sector auditing is under public scrutiny and political pressure. Most citizens look at the audit function as a governance failure because of its incapacity to drive public administrations towards higher level of performance and to prevent maladministration. On the other side, politicians see auditing as a way for recovering public administrations' legitimation at the societal level. The performance of auditing in the public sector is the result of practices carried out by networks made up of subjects, rules and techniques which (inter)act differently according to their evolving association along time, also depending on different contingencies. The public sector has experienced and still experience a continuous reform process implemented at the international level differently and at different pace, resulting in practice variations in the field of auditing (Pollitt, 2003). But, at the moment, these different practices are not well and deeply analysed and compared (Hay & Cordery, 2021). This book aims at providing a contemporary overview of public sector auditing models and practices adopted in different countries. In particular, the overview will be focussed on the auditing practices developed during the last two decades and on countries that have experienced different reform processes of their public sector. More specifically, the countries included in the book belong to public sectors characterised by different administrative and political cultures (i.e. Westminster tradition, Nordic tradition and Napoleonic tradition) but also countries not yet well studied such as Brazil and China.

To provide a more focussed and deeper understanding and analysis of auditing models and practices and to enhance comparability, the various chapters will focus on a single institutional level, the local level. During recent years, most of the research has concentrated more on central government, specifically on Supreme

Audit Institutions, their structures and aims (Blume & Voigt, 2011; Cordery & Hay, 2019, 2021; OECD, 2016). More limited has been the interest for local public administrations and the changes/variations that auditing has experienced during recent years as a consequence of the reform process that has affected this type of administrations (Ferry, 2019; Ferry & Ahrens, 2021; Ferry & Eckersley, 2015; Manes Rossi, Brusca, & Condor, 2020). Additionally, the local level is much more differentiated, especially in terms of size, implying the possibility that different auditing models and practices have been adopted in the same country.

In this introductive chapter, we want to outline the reasons why auditing deserves attention at the academic and professional levels, the subjects that are involved in auditing processes and their characteristics and the objects of those processes. All these are the dimensions which have informed the design of the standardised structure presented in the last section of this chapter and used by authors for writing their contributions. The aim of this standardisation has been a higher comparability of the chapters useful for detecting and analysing commonalities and differences in auditing of local public administrations in different countries.

In this book, we examine local government audit using the framework provided by the literature surrounding regulatory space. Regulatory space is a socially constructed abstract space subject to decisions of agents of the state through regulation. There has been a global debate about the suitability of these spaces to achieve the ends they are designed for (Hancher & Moran, 1989). Audit has been described in these terms by a number of scholars who have addressed the question of whether the regulatory space of audit achieves its objectives (Ferry & Ahrens, 2021; Free & Radcliffe, 2009; Hancher & Moran, 1989; Humphrey, Loft, & Woods, 2009; Malsch & Gendron, 2011). Audit crises in the private sector have been analysed to assess how far they undermine the operation of capitalist markets (Mueller, Carter, & Whittle, 2015). In the public sector, recent crises in audit have also challenged the conceptual foundations of the legitimacy of the democratic state (Ferry, 2019; Public Administration and Constitutional Affairs Committee, 2017).

Andon, Free, and Sivabalan (2014) suggested that new audit spaces had been opened up and that this presented a challenge to the regulatory space of audit. Andon, Free, and O'Dwyer (2015) extended this and identified public audit as a new audit space that coalesced around four themes: professional accreditation and institutionalised capital, independence, reporting and the mediating roles of audit. Ferry and Ahrens (2021) used this model to examine the regulatory space in local government audit in the UK: comparing the four components of the UK (England, Northern Ireland, Scotland and Wales) with regard to the regulatory space of local government audit. They adapted Andon et al. (2015) for the context of local government and identified four themes: audit fragmentation, audit independence and competition, audit scope and inspection through which they performed their analysis (Ferry & Ahrens, 2021). Ferry and Ahrens (2021) described this comparative work as the 'first step towards the comparative study of audit regulatory space in different countries' and suggested that future research might use the model in 'comparative projects with countries that follow the Westminster

model, or other countries that follow different models'. This book fills this gap identified by Ferry and Ahrens (2021) by providing a comparative analysis of 14 different countries using their framework as a roadmap.

## 1.2. Why Auditing: Models and Practice Variations, Accountability and Performance

There are various reasons which explain why auditing is a subject deserving the interest of academics and practitioners. Among others, the most relevant are related to understanding the similarities and differences existing among audit institutions and auditing practices in various countries and the effects they produce on accountability and performance of public administrations.

Auditing is a field of activity that has been established all over the world. Historically, in the private sector auditing has been enmeshed with the development of modern capital markets (Flesher, Previts, & Samson, 2005). In more contemporary times, this linkage between market capitalism and auditing has been confirmed by the evolution of the auditing sector in the post-communist countries (Mennicken, 2010, p. 334). In the public sector, the origins of audit are older, being connected to the continuing development of stewardship of the state and constitutional government (Ferry & Midgley, 2021; Funnell, 2007; Funnell & Dewar, 2017; Midgley, 2019). The demands of capital markets in the private sector and for greater accountability around use of state funds in the public sector has led to audit taking on an ever increasing role for good governance.

The reform process that has generally impacted public sectors all over the western world through neo-liberalism and new public management (NPM) has led to adoption of market mechanisms and importing of business disciplines (Hood, 1991; Hyndman & Lapsley, 2016), with auditing becoming an increasingly constitutive element of public administrations. The ideas and practices of audit are often perceived to travel across countries and be similar of a consistent nature (Lapsley, 2009; Power, 2000). The mimetic behaviour adopted by the legislator in different countries for settling their public audit institutions and auditing practices has furtherly supported this idea (Cordery & Hay, 2021). But despite this perception and various efforts done to reach a higher harmonisation, audit institutions and auditing practices are still very different among countries (Manes Rossi et al., 2020). Therefore, a better knowledge of the different auditing models in place across countries is relevant for evaluating their value. For instance, an auditing model and its operating conditions in a country could differently participate and/or contribute to the achievement of certain performance of public sector organisations compared to the same or another model in place in another country and could sit constitutionally in a different place within that country's political architecture (Ferry & Midgley, 2021; Funnell & Dewar, 2017; Normanton, 1966). The knowledge of these models, their operating conditions, the constitutional place of each specific auditor and the effects on public performance are necessary to evaluate the possibility for a certain model to be transferred in another country or to define a translation process of that model in a different

environment characterised by specific operating conditions. Only this knowledge will avoid an uncritical transfer of auditing models and their potential negative future effects on public sector performance and the substance of democracy in each different state (Bracci, Humphrey, Moll, & Steccolini, 2015).

Auditing has been increasingly considered as an activity able to contribute to financial stewardship and performance management, playing an increasing role in accountability and transparency arrangements in the public sector (Ferry, Eckersley, & Zakaria, 2015; Ferry & Eckersley, 2015; Murphy, Ferry, Glennon, & Greenhalgh, 2018). Even if the implementation of good management and governance depends on the objectives to be reached, an effective auditing should contribute to guarantee that members of an organisation are pursuing the objectives defined through the planning process. Auditing should indirectly foster people working in an organisation to follow organisational procedures compliant with the organisational standards and rules. At the society level, auditing should provide the reassurance that an organisation has behaved in compliance with the rules governing a social system at that time. In this perspective, auditing is a fundamental activity for increasing the possibility/probability for public administrations to achieve their performance, and maintain their legitimation in collecting, planning and spending the public resources received through the taxation system. Good quality auditing may assist in re-establishing trust between the citizen and governments in some countries (Heald, 2018) and to reduce corruption even if it is not its focus (Gustavson & Sundström, 2018).

## 1.3. Who Is the Auditor?

The question raised in the title of this section 'Who is the auditor?' is at first glance, apparently, very easy to answer but it depends on the perspective we want to adopt: the design of an auditing model or the realisation of an auditing process. Focussing on the latter, this 'who' is mainly the auditor(s). Therefore, the problem is to understand what type of subject this auditor is and who has the possibility to become an auditor.

The auditor is the subject in charge of verifying the accuracy of an organisation in being compliant with the rules and standards existing in a certain environment for managing the object (we speak about it in the next section) of the auditing process to reach the objectives settled for the audited entity. Despite the number of auditing institutions and auditors that could be involved in auditing processes of public administrations, an auditor could be a public or a private subject/entity usually enrolled in a list regulated by the law (Johnsen, 2019). In particular, we have countries adopting auditing models characterised by auditors similar to judges, or models where the auditors are much more similar to accounting professionals as in the private sector or even models mixing both types of auditors (Manes Rossi et al., 2020). Apart from the legal status of these subjects that should be perceived more as an organisational dimension functional to auditing, what is relevant concerns auditors' capacity to produce good auditing. In general, good auditing is performed when an auditor has a high level of independence and professionalism (Gustavson & Sundström, 2018).

The principle of auditors' independence has been strongly supported by researchers and has been boldly defined since the issuing in 1998 of the Lima Declaration, the first International Standard of the International Organisation of Supreme Audit Institutions (INTOSAI, 1998). An independent auditor should produce information that are more reliable than the information produced by any other subject, consequently being more trustable by citizens. Only this condition can give auditing the role it could and should have in the governance system of our society (James, 2011). The independence we are speaking about should refer to the financial and non-financial dimensions of auditors' activity. As for the former, auditors should be financially independent, that is their revenues must not be linked to the outcome of their audit judgement. For the latter, they must be free in defining planning and executing the auditing activities. However, there are concerns about independence if interpreted too broadly. Ferry and Midgley (2021) warn that it cannot detract from the constitutional function of the auditor and state for central audit institutions it is clear that independence must be subordinate to the democratic objective of audit. Ferry and Ahrens (2021) warn about the possibility that an extreme defence of auditors' independence could hamper the competition mechanism among auditors, leading to a worsening of auditing quality. They state that:

> independence needs to be balanced against benefits from competition, which is concerned with the audit expertise on offer and the sustainability of the market for this expertise. There are important interdependencies between these two characteristics of auditor independence and competition in local government audit, and both are fundamental to the creation of trust in the public audit function (p. 11).

With reference to professionalism, auditors should be better able than ordinary citizens and politicians to plan and perform the activities necessary for producing a good audit. The professionalism of auditors is essential mainly for two reasons. First, public administrations are becoming increasingly complex, making them less understandable for citizens because of the asymmetric availability between public servants and citizens and politicians of the necessary knowledge and information. In this asymmetric situation, only a professional subject, working as an auditor, can be a reliable and trustable linkage between the subjects in the asymmetric relationship. Additionally, professionalism is necessary to permit auditors a better understanding of such complex organisations and provide better judgement to the audited entities, thus contributing to the improvement of their performance. Second, professionalism could be an element able to reduce familiarity between auditee and auditor thus strengthening the reliability and trustworthiness in the judgement released by an auditor. Professionalism is a way for limiting the identification of auditors with their auditees because higher would be the auditors' identification with their profession. According to Bamber and Iyer (2007, p. 1),

> auditors do identify with their clients and that auditors who identify more with a client are more likely to acquiesce to the client-preferred position. On the other hand, more experienced auditors and auditors who exhibit higher levels of professional identification are less likely to acquiesce to the client's position.

Additionally, the lack of professionalism creates more dependency of auditors on their auditees because limited is their possibility of taking a critical stance towards the information obtained in the audit process. Professionalism coupled with a strong auditor rotation represent a useful driver also for increasing auditors' independence (Moore, Tetlock, Tanlu, & Bazerman, 2006).

## 1.4. The What of Auditing Processes

The last aspect we want to discuss for clarifying the content of this book is related to the scope of auditing and its evolution along the reform process experienced by the public sector. The scope of auditing is relevant in itself but it is also linked to the other aspects discussed in the previous section. Different objects to be audited could imply the necessity to have a different professionality from the auditor because different are the knowledge and skills required. Furthermore, auditing of a wider scope could imply a different level of interaction with audited entities, thus reaching higher level of familiarity at the risk of decreasing auditors' independence.

Currently, the scope of auditing in the public sector 'spans different activities such as financial audit, compliance audit and performance audit' (Johnsen, 2019, p. 122) but it has experienced an evolution cycle mainly due to the increase in the size and complexity of public sector organisations and the consequent request of a higher level of accountability. According to Posner and Shahan (2014), auditing has had three evolution waves.

The first wave was mainly characterised by a focus on the regularity of financial transactions. Auditing aimed mainly to prevent corruption and most of the auditing activities were directed at the *ex ante* stage to verify the compliance of public spending processes with laws and regulations.

The second wave was characterised by an increasing complexity of public administrations resulting in an excessive number of transactions to audit. This made it impossible to continue to exert an *ex ante* auditing covering all the financial transactions carried out by public administrations. Therefore, the auditing focus moved to internal control systems to verify their capacity of oversighting the activities of audited entities. Through the auditing of a sampling of selected transactions, the good functioning of internal control systems was inferred and therefore all transactions were judged as valid and reliable. This contributed to the development of a chain of controls operating not for verifying the reliability of an activity carried out by an audited entity but for controlling the controller (Power, 2000). Consequently, many regulators started to be settled.

The last wave, mainly driven by the spreading of the NPM and still having to fully deploy its effects, has determined the shift of auditing focus from financial transactions to public administrations' performance. INTOSAI (2019, p. 8) has defined

> performance auditing *as* an independent, objective and reliable examination of whether government undertakings, systems, operations, programmes, activities or organisations are operating in accordance with the principles of economy, efficiency and effectiveness and whether there is room for improvement.

The scope of auditing has been enlarged making necessary a deeper interaction between auditors and auditees for performing a good auditing. Hierarchical model of auditing could result as less suitable for the wider scope of performance auditing (Roberts, 1991). The result of auditing processes cannot be any more the production of auditees' self that are driven by compliance objectives. Auditing should make auditees perceiving their self as participating in a cooperative process. Single auditees can ameliorate their self not detaching themselves from others they work with but interacting strategically with them because anybody is interdependent from others to pursue his/her performance. Only the adoption of this approach will lead auditing to contribute to organisational performance.

It could also be argued that a fourth wave of auditing is now underway, with developments in digitalisation, data analytics and artificial intelligence. This is, and will continue, to radically change auditing as we live in a digital world.

Despite the enlargement of the auditing scope, some scholars are sustaining that the three-Es – economy, efficiency and effectiveness – auditing model is not able to frame a comprehensive scheme of analysis coherent with the characteristics of a public administration. It is not sufficient for a public administration to provide public services respecting the principles of economy, efficiency and effectiveness. These principles, which are relevant not only for auditing but also for the evaluation and reward systems of public employees, focus the attention on single element of public administrations' public service production (i.e. the inputs and the related economy dimension) or on the linkage existing between two elements (i.e. efficiency and effectiveness which link together respectively inputs–outputs and outputs–outcomes) but they do not consider the process which link together those elements and how people behave and perform to obtain them (Mussari & Ruggiero, 2010). To fix this shortage, Bringselius (2018) sustain that the auditing model should become a four-Es model where the last E represents ethics. Ferry (2019, p. 2) commenting on audit in English local government states that:

> Public audit should, and should be seen to, serve the public interest. Public audit is not just another professional service. The audit and inspection system is not broken in terms of what it does, but the question is whether it does the right thing. Currently, for local government, it is known what local authorities have spent