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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.<sup>1</sup>

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

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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,<sup>2</sup> 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.<sup>3</sup> 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).<sup>4</sup> 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, &

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

<sup>3</sup> 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).

<sup>4</sup> 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.

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