

# INVESTIGATION 1

## The Value of Public Audit: Literature and History

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# **The Value of Public Audit: Literature and History**

## **Chapter 1: Introduction**

This paper examines the value of financial statement auditing in the public sector. While public sector auditing is well-established in New Zealand and most other countries, the environment in which it takes place is subject to continuing change. In addition, Supreme Audit Institutions are required by their professional standards to demonstrate their ongoing relevance to citizens, Parliament and other stakeholders. The study applies theory about auditing from the private sector as well as the public sector to explore ways in which public auditing sector can be expected to be valuable. Evidence from history is also examined. The paper concludes with a set of issues that require further investigation, and suggestions about how public sector auditing can and should change in the future.

### **1.1 Investigation**

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 summarises evidence that public sector auditing adds value, and develops suggestions about how its benefits might be increased. It also develops issues for further research.

A number of explanations for the function and value of auditing can be found in the auditing research literature.<sup>1</sup> The explanations are directed at private sector auditing, but can be adapted to the public sector and can be used to compare private sector and public sector auditing. The explanations are: an agency role; an information role; an insurance role; an organizational control role; a confirmation role; and a risk management role. The benefits of public sector auditing as a public good, the positive externalities of auditing and other theoretical explanations are also discussed.

These explanations are presented first, and 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 role of a Supreme Audit Institution can include financial statement auditing (including reporting on performance measurement), performance auditing and investigations. In New

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<sup>1</sup> Discussed in the Routledge Companion to Auditing (2014) edited by Hay, Knechel and Willekens.

Zealand, approximately 87% of the work of the Office of the Auditor-General is financial report auditing, and the following discussion concentrates mainly on that function. We also refer to performance auditing and inquiries where appropriate.

## **Chapter 2: Literature review - auditing**

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 decades of audit failures and auditing scandals (for example the United States) auditing is in high demand and the response to audit failures is generally to require more auditing, not less.

### **2.1 The agency (or monitoring) explanation**

Under this 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. One of these relationships is between a company owner and a manager. 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 then 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 1992). There is historical evidence that audits were sometimes arranged voluntarily in just this way before there was legislation requiring them (Wallace, 1980; Chow 1982). Research in the private sector provides evidence that Big N audit firms,<sup>2</sup> which are

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<sup>2</sup> 'Big N' – now Big 4, but previously Big 8, and so on.

perceived to provide higher quality, charge higher fees (Simunic 2014 p. 36). They also have less litigation brought against them (Simunic 2014 p. p. 39).

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. A partner in the US firm of KPMG wrote that “auditing adds tremendous value” (Elliott, 1994). Elliott estimated that audits reduce the cost of capital for the companies being audited by from 1% to 3%. Empirical studies suggest that this is overstated, although the effect still exists.

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 (Salamon and Dhaliwal, 1980; Chow, 1982; Pincus et al., 1989).

Agency theory is applicable to the public sector (Jensen and Meckling, 1976, p. 309) and has been used to explain issues related to financial reporting and auditing in previous public sector studies (Zimmerman, 1977; Baber, 1983; Baber and Sen, 1984; Ingram, 1984; Baber, Brooks and Ricks, 1987; Ingram and DeJong, 1987; Marks and Raman, 1987; Carpenter, 1991; Lim and McKinnon, 1993; Giroux and McLelland 2003; Jensen 2005; Kido et al. 2012; Bradbury and Scott, 2015). Explaining agency relationships in the public sector is more complex than in the private sector as there are several levels of relationship (Streim, 1994).

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) 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 choose 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, organizational control (discussed below).

There are a number of sources explaining that the New Zealand reforms to public sector management in the 1980s and 1990s were based on agency principles (e.g., Scott et al. 1997).<sup>3</sup> Hay (2001 and 2003) 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 decentralisation of an activity (Hay, 2001), and that the extent of decentralisation is related to the knowledge transfer costs and extent of dependence associated with a public sector activity (Hay, 2003).

The agency relationship between Parliament and government is the explanation for public sector auditing that is the primary focal point of most published material from researchers and policy makers. This agency relationship has been important since about the 1860s in both the United Kingdom and New Zealand. Earlier, the audit function was more concerned with organisational control and with the relationship between central government and the public service.

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<sup>3</sup> Scott and Gorringer, 1989, p. 81; Martin, 1990, p. 135; Boston, 1991, p. 1; Hood, 1991, p. 6; Ball, 1992, p. 7; Boston, 1992, p. 409; Wistrich, 1992, p. 119.

Pallot (2003) reflects on the New Zealand public sector reforms of the 1980s and 1990s, using the term “a wider accountability.” She notes the underlying framework of the New Zealand public sector reforms lies in public choice theory, agency theory and theories of property rights and transaction cost economics (Pallot 2003, p. 133). She contrasts the model of managerial accountability proposed by the Treasury with a wider notion of accountability, which she calls public accountability, democratic accountability or constitutional accountability (Pallot 2003, p. 135). Her “wider accountability” can also be seen as accountability focused on the agency relationship between Parliament and the executive, as opposed to Treasury’s focus on accountability from bureaucrats to the executive (although Pallot does not depict it in these terms). She also reviews the history of the changes that affected the Audit Office. Wider accountability includes a focus on outcomes. “The logic of the outputs/outcomes split is that outputs are a suitable basis for ‘purchase agreements’ between departments/agencies and ministers but that ministers are accountable to parliament and the public at large for outcomes.” However, ministers report to Parliament on the outputs using the reports of the departments, not on outcomes (Pallot 2003, p. 142). She reviews criticism of this model in the Audit Office’s 1999 report *The Accountability of Executive Government to Parliament*, which concludes that government statements about outcomes are high-level and vague (Pallot 2003, p. 148). Reflecting on Pallot (2003), it is understandable that this is the case. The model whereby outputs are reported on but not outcomes appears to be useful not simply to avoid wider accountability, but because outputs can be negotiated between a minister and a chief executive. There is not a similar mechanism for negotiating outcomes with Parliament or the electorate, so that the accountability mechanisms are more vague. Hay (2003) shows that greater accountability occurs when more authority has been delegated by Ministers.

Hay (2001) shows how the various organizational forms in the New Zealand public sector (such as State-owned Enterprises, Government Departments, local government and crown entities) have different structures with varying degrees of decentralization. Where there is more decentralization there tends to be more accountability. The different organizational forms 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.



Jensen (2005) 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.

Previous public sector research studies applying agency approaches include Schelker (2013) who 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 qualifications, 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).

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, 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 variables are included for GDP, trade, civil liberties, proportion of the population over 65, ethnolinguistic fractionalisation, 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 are associated with greater corruption (Blume and Voigt p. 215).

They report that “differences in the independence, the mandate, the implementation record, and the organizational model of the SAIs do not seem to have any clear-cut effect on any of the three groups of dependent variables. There is only one exception: perceived levels of corruption are significantly higher if the SAI is structured along the court model of auditing” (Blume and Voigt, 2011 p. 215). The dependent variables include measures of fiscal policy,

government effectiveness and corruption, and productivity. Their auditing data is drawn from surveys by the World Bank and by INTOSAI. Blume and Voigt (2011, p. 226) note that their study is the first to analyse the effects of the organizational set-up of Supreme Audit Institutions 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 and Voigt 2011, 226).

Summarising 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, less 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. So far as performance audits are concerned, they provide value to the principal in the principal-agent relationship by providing assurance that efficiency and effectiveness are assured.

## **2.2 The information (or signalling) 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, information asymmetry may result in their claims not being believed. They can overcome information asymmetry by engaging an auditor to provide assurance about their statements (or by engaging a higher quality auditor). Information asymmetry is closely related to the agency explanation, as the reason for the agency issue is information asymmetry between the agent and the principal.

Public sector entities often have reasons to attract investors (for example in bonds), so that there are public sector parallels to this explanation. Other stakeholders such as voters also suffer from information asymmetry, so that the information explanation can also apply more widely to the public sector. However, rational voters may find that the benefits to them personally are not sufficient to match the costs of taking an interest in public sector information.

With perfect information the agency problem does not arise and there is no need for signalling. While it is common to question the quality of capital markets, many observers believe that they work well in comparison to political markets. Thus, audits of listed

companies can be regarded as an attempt to reduce information asymmetry for the analyst community. In contrast, it could be argued that public sector audits provide comfort that it is reasonable to ignore any information intended to reduce information asymmetry, that is, to be rationally ignorant.

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 the information effect could carry over to the non-profit sector, and asks, "Do non-profit entities that issue audited financial statements receive greater contributions?" In a not-for-profit setting, Hay and Davis (2004) argued that the signalling explanation could also apply to New Zealand incorporated societies. In the public sector, where audits are required and entities cannot choose their own auditor, the voluntary aspect of signalling does not apply to individual entities, but it may nevertheless be helpful for financial report users to have higher quality information for other reasons such as those below. Gore (2004) shows that municipal governments have incentives to disclose more information that are related to their financing from the bond market.

For the government as whole, signalling 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 to do so. In practice, in NZ, government information is accepted, for example there is generally no dispute over figures announced by the government such as the annual surplus or deficit.

This signalling explanation can also be applied to individual public sector entities. At time of the 1980s reforms, some of the newly-formed State-Owned Enterprises 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 (Pallot, 2003; Green and Singleton, 2009). Local councils also borrow on international markets. Signalling theory might also apply in other settings where stakeholders have an interest in credible information.

The signalling or information explanation is complementary to the agency explanation. If there was no auditing, managers would have less ability to attract investors or to convince other users that their financial statements are credible. Signalling 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.

### **2.3 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 (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) suggest 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.<sup>4</sup>

In addition there have been several cases where legal action for monetary losses has been brought against the Auditor-General of New Zealand (Green and Singleton, 2009, pp. 82 and 145).<sup>5</sup>

Insurance over financial statements or decisions by managers is not the intended purpose of auditing in the public sector, but auditing may be valued for that reason. If there was no auditing, some investors would be reluctant to invest for this reason, along with agency and signalling. The expectation gap, particularly where financial report users have unrealistic expectations of what an audit can achieve, is related to this issue. The insurance explanation is less relevant to performance audits and inquiries.

There is considerable overlap between the agency, signalling and insurance explanations and the three explanations work together.

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<sup>4</sup> The auditor accepting some responsibility is something which occurred in the case of Kaipara District Council. In 2013, the Auditor-General apologised. According to Radio New Zealand News (2013), 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.”

<sup>5</sup> 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).

## **2.4 The organizational control explanation**

Organizational 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.

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 this 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.<sup>6</sup>

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 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). It might be expected that the extent of internal and external audit would also be greater for decentralized activities.

The organisational control explanation is that auditing is also beneficial in helping managers to control large complex entities. That task would be more difficult without auditors of the financial statements who can also observe activities at remote locations and make recommendations to management.

Performance audits and inquiries are intended to provide information about controls to Parliament and other stakeholders and can also provide benefits to managers of organisations by bringing issues to their attention.

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<sup>66</sup> A similar function can be carried out by internal audit in many large entities. It will be useful to take stock of the extent on internal audit in the public sector.

## 2.5 The confirmation hypothesis

Announcements by companies, such as profit announcements, often have little impact on share prices. This finding was reported in a well-known paper by Ball and Brown (1968) and has been well documented since. The share market reacts to earnings “surprises” but not to historical data. As a result, announcements of past profits, and the release of detailed audited financial information, are sometimes regarded as less important than announcements of new, price-sensitive information. Under the confirmation hypothesis, announcements about past financial performance and position are important because they verify earlier unaudited announcements. Ball et al. (2012) suggests 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. 136). This is the confirmation hypothesis. It suggests that while unaudited announcements have more market impact, it is still necessary for announcements to be independently verified at a later stage. This is done by the issuing of an audited financial report covering the results for the year.<sup>7</sup>

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 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 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. It

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<sup>7</sup> Similarly, Sorter (1979) 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.”

will be useful to investigate what announcements are made that may be relied on because they are supported by subsequent audit announcements.

The confirmation explanation shows how users of financial reports can rely on the latest financial information, even if it is not audited, because later on it will be confirmed by an audited report. Without auditing, unaudited information would also be less useful. This explanation is less applicable to performance audits and inquiries.

## **2.6 Risk management and corporate governance**

Auditing can be useful for organizations whose stakeholders are subject to higher risk. It is closely associated with corporate governance. Other mechanisms are also used to reduce risk, such as internal audits and processes, 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 minimise risk. As a result, the demand for auditing, or for higher-quality auditing, can be higher when there are other governance mechanisms in place. Bedard and Compennolle (2014, pp. 256-259) show 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. The function of auditing in risk management complements other forms of governance. 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.

Knechel and Willekens (2006) show that demand for external auditors increases in situations where there are more governance mechanisms, for example when there is an audit committee or when there are more independent directors. They suggest that these other parties increase their demands for higher quality auditing so that they can perform their own functions better, and to reduce the risk to their reputation that might be caused by accounting errors or financial problems. Hay, Knechel and Ling (2008) in a study examining New Zealand public companies in 1995 and 2005 showed that there was evidence that better corporate governance is not a substitute for auditing, but is complementary to it, consistent with that explanation.

This explanation might be especially relevant to public sector entities that have governance mechanisms similar to those used in the private sector, such as independent directors or audit committees. In these cases, the audit might also be valuable to these parties. It will be useful

to consider the extent of audit committees in the New Zealand public sector. It is also useful to consider other overall controls within the New Zealand government.

The Sharman (2001) report into public sector governance in the UK includes recommendations that all central government bodies should follow the principles of the Turnbull Report (on governance of listed companies) and have these governance mechanisms: a formal internal control statement signed by the Accounting Officer; a formal, independent, audit committee; and access to internal audit (Sharman 2001, p. 1). The report also suggests considering environmental auditing for public sector entities (Sharman 2001, p. 54). The report commends a suggestion the UK National Audit Office should be subject to review by the Institute of Chartered Accountants in England and Wales (Sharman 2001, p. 55).<sup>8</sup> Jensen and Payne (2003) show 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. Jensen (2005) shows that their ability to do this depends on the level of agency costs.

Governance of private sector and public sector entities has been developed extensively in recent decades. In 1995, comparatively few New Zealand listed companies had audit committees; by 2005 almost all did (Hay et al. 2008). The change followed from international developments, recommendations by the Securities Commission and changes in the Stock Exchange listing requirements. 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 their level of agency costs.

The role of auditing in risk management and corporate governance is a complex one. However, auditing is an important part of governance. Better governance tends to lead to

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<sup>8</sup> McPhee (2012, p. 1): The Australian National Audit Office ANAO adopts the auditing standards of the AUASB. McPhee (2012, p. 9): the ANAO uses external reviewers for annual inspection of a selection of audits, using Big 4 audit firm partners.



more auditing. Without auditing, it would be much more difficult for good governance to take place.

Auditing is also beneficial in helping those in charge of the governance of large complex entities. That task would be more difficult without auditors of the financial statements who can provide assurance about their reliability. Performance audits and inquiries are intended to provide information about controls to Parliament and other stakeholders and can also provide benefits to those involved with governance by bringing issues to their attention.

## **2.7 Public benefits, externalities, public choice and other explanations**

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.

Auditing has direct benefits to stakeholders. Hay, Knechel and Willekens (2015, p. 12) provide an explanation of auditing as a public good. In the private sector, many stakeholders benefit from an audit, even if they are not involved in hiring and compensating the auditor. 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 (for the reasons discussed above). Legislators therefore impose auditing requirements for the benefit of the community.

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) describe Supreme Audit Institutions as an important institution that has been neglected in research so far. They analyse 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. “

Pearson (2014, p. 152) 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. Likewise, the adoption of “new public management” which also led to more reporting.

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 (World Bank, 2007). Rajan and Zingales (2000, 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 INTOSAI. Public sector auditing could 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 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). NZ is 3rd on lack of corruption, 1st on number of accountants, CIFAR is not stated in the paper, although other sources show that New Zealand has a score of 80, the same as Australia or the US (Bushman et al. 2004).

Private sector auditing is regulated in most jurisdictions, perhaps to provide these benefits to the economy, or to provide for auditing under the agency or signalling explanations. Since the beginning of the twenty-first century, there has been a move from self-regulation of auditing to independent regulation in most countries with similar economic systems to New Zealand. In New Zealand, these reforms have included oversight and inspection of licensed auditors by

the Financial Markets Authority; and standard setting by the New Zealand Auditing and Assurance Standards Board (part of the External Reporting Board). Some other countries have required auditors to express an opinion on internal control as well as on the financial statements (the United States, Japan and China). There are current international proposals to require auditors to report more extensively, including reporting in their audit opinions on the key audit matters that arose during the audit.

“Public choice” explanations include an alternative set of views about regulation. 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 Enron 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-maximising bureaucrat can also be considered. An Auditor-General might be expected to have incentives to maximise 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 and 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 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 and Powell (1983). They consider that the public sector is more subject to that set of influences than the private sector. These pressures are for mimetic, coercive and normative isomorphism. 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.

Everett et al. (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.

## **2.8 Summary 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. They send a positive signal to potential lenders and other investors. Some parties may see audits as providing an insurance function. Audits also have less direct benefits in helping top management keep control of the organization that they are responsible for. Auditors are also increasingly important as part of corporate governance, and can be of benefit to the organisation as a whole and to directors. In addition, auditing provides benefits for the community as a whole.

## **Chapter 3: Evidence from history**

Historical examinations of the role of accounting and auditing provide, at the “big picture” level, 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 explanations reviewed in the first part of this document (agency, signalling, insurance, management control, governance and public benefit) also appear as part of the development of public sector auditing, although the extent to which they are applicable varies.

### **3.1 The history of public sector auditing in the Westminster system**

Works of general history show that public sector accounting and auditing are important in national history. 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. The role of public sector auditing in Westminster systems continues to evolve, for example in New Zealand with the legislation of 2001. Public sector auditing could be done differently, and in 1988 a Parliamentary committee considered the issue of whether the public sector Audit Office could be replaced by private audit firms.

Recent publications in the field of historical research show the importance in national histories of strong public accounting systems. Ferguson in *The Cash Nexus* (2001) examines the argument that prosperity and democracy are linked to each other. Ferguson (2001) points out the strengths of the British system’s “square of power” (the tax-collecting bureaucracy, Parliament, the national debt and the central bank) was advantageous compared to other countries, for example because the need for a tax gathering bureaucracy “implied a need for a system of formal education, to ensure an adequate supply of civil servants who were both literate and numerate” (Ferguson, 2001, p. 77 of 1729). This argument suggests that accounting and related activities have positive externalities.

In addition, stronger financial arrangements could be decisive in war. Ferguson (2001):

“In 1788, according to modern estimates, French GNP was more than double the British; the French population nearly three times larger; yet despite being economically inferior, Britain was able to mobilize more men and ships at lower relative cost than her rival. Thanks in large part to the superiority of British fiscal institutions, the ratio of British to French warships rose from 1.3: 1 in 1780 to 3.5: 1 in 1810” (Ferguson 2001 p. 1291-2 of 1729).

Auditing in the public sector was not well-developed at this time, but the presence of superior fiscal institutions may have had a signalling effect that attracted investors.

In *The Reckoning*, Soll (2014) argues that: “those societies that managed to harness accounting as part of their general cultures flourished.” He gives as examples Republican Italian city-states like Genoa and Florence, Golden Age Holland, and eighteenth- and nineteenth-century Britain and America, and argues that in such places accounting was included in education, religious and moral thought, art, philosophy, and political theory. “Among educated citizens, there was an expectation that those in power, from municipal administrators to educators to princes, knew accounting and had a sense of just how essential financial accountability was to their republic system” (Soll, 2014, pp. 552-553 of 687).

Auditors were also present in early accounting. Soll reports that Athenians in ancient times preferred to use slaves as accountants or auditors because it was permissible to torture them when necessary (Soll, 2014, p. 37 of 687). The Athenians had extensive audits of public expenditure, although a certain level of fraud was still tolerated (Soll 2014, p. 39 of 687). According to Stone (1969) Athens in the time of Pericles required that contractors of public buildings included the receipts and expenditure for the building to be carved in stone on the outside of the building.<sup>9</sup> By this custom, according to Stone (1969, p. 287) “each citizen became an auditor.”

In medieval times, audits were practised by guilds of artisans over the accounts of manors and to some extent in government. Watts and Zimmerman (1983, p. 617) show that there were audits as early as 1200 (in the merchant guild of Ipswich). They trace the development of audits from medieval guilds to companies of merchant adventurers and later to joint stock companies. Audits were conducted by members or shareholders, sometimes acting together with directors of the company. Audits were not regulated but evolved, not because of government fiat. Their evolution is explained as a way to overcome agency problems (Watts and Zimmerman 1983, p. 633). Watts and Zimmerman portray auditing in these circumstances as “one type of monitoring activity that increases the value of the firm (Watts and Zimmerman, 1983, p. 613). Watts and Zimmerman (1983) provide their historical evidence as support for the agency explanation of auditing.

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<sup>9</sup> The Parthenon cost 469 talents of silver (Stone, 1969, p. 287). A talent of silver was 26 kg. At current prices, 469 talents is about US \$6 million.

Auditing of public expenditure also existed, but appears 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 labours produced worthwhile results” Einzig (1959, p. 117). Soll (2014, p. 51 of 687) observes that the king’s personal revenue and expenditure, which were enormous were generally kept secret. King Edward III stated that “Kings do not render accounts except to God.” At this time the potential benefits to the executive government of auditing as a way to reduce agency costs do not appear to have been recognized. In addition, the relationship between Crown and Parliament had not 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. Audits were requested by Parliament, which was not yet recognized as the principal, without great success.

Manorial audits were an important part of estate management in England in the thirteenth and fourteenth century, and include an oral examination of the steward and his accounts (Maltby, 2009a, p. 231). Double entry accounting was developed in Italy and was very useful in business and in government.<sup>10</sup> The Commune of Genoa used double entry accounting for the city’s transactions from 1340 onwards and required annual audits (Soll, 2014, p. 62 of 687).

Soll (2014, p. 73 of 687) describes in some detail the double entry accounting records kept by Italian merchants. Ledgers sometimes commenced with a religious statement, in some cases “In the name of God and profit.” This invocation was partly because accounting, being associated with banking and thus usury, was considered slightly immoral (Soll, p. 63 of 687).

The Medici family accumulated great wealth in the period 1380 to 1464, had business activities around Europe and made use of double entry accounting and of internal auditing (Soll, p. 107 of 687). The head of the family was generally the chief investor in all of the business activities, and also the chief auditor (Soll, p. 115 of 687). Soll shows how later generations with a classical education and a lack of accounting skills reduced the Medici family wealth to almost nothing (Soll, p. 140 of 687).

Roseveare (1991) like Ferguson, notes the importance of the financial system to military power. In the 1660s, England suffered at the hands of the Dutch “a resounding defeat which

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<sup>10</sup> Although Pacioli wrote the first well-known treatise on double entry accounting in 1494, the method had been in use in Italy for about two centuries by then (Soll, 2014, p. 142 of 687).

derived in large part from the mismanagement and financial inadequacies of English government” (Roseveare 1991, p. 1). But in the 1760s, Great Britain “financed her own military campaign with comparative ease and sustained her allies” (Roseveare 1991, p. 2). The difference is called by Roseveare the “Financial Revolution” including “Parliamentary control of government finance at the cornerstone of the constitution” (Roseveare 1991, p. 31). He also cites the lessons learned from the South Sea Bubble (Roseveare 1991, p. 59), especially the government issue of ‘Consols’ (government stock) (Roseveare 1991, p. 61). Roseveare also observes that Parliamentary audit had been demanded in 1624, but “conspicuously failed to take root” (Roseveare 1991, p. 15).

Ferguson (2001) 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” (p. 52 of 1729). Ferguson’s source for Parliament’s right to audit is North and Weingast (1989). They in turn 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.” (North and Weingast 1989, 817). They also state that “controlling Crown behaviour 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 and Weingast 1989, 816). North and Weingast (1989) in turn refer to Dickson (1967).

The Glorious Revolution in 1688 marks “the beginnings of the period of full Parliamentary control over the public purse” (Einzig 1959, p. 122). However, the British political system in the 18<sup>th</sup> was “democracy tempered by corruption” – including the Executive spending public funds on election bribes (Einzig 1959, p. 122). Auditing in the public sector had now become possible, but still required further development.

Dickson (1967) traces the somewhat slow development of the audit function in the UK, and its emphasis on internal control rather than audit. Dickson (1967, p. 381): “In October 1725 the further office of Comptroller of Exchequer bills was instituted. The Comptroller’s duties were defined in 1755 as the cancellation of bills each week (presumably after the paymasters had paid them), the inspection of the paymasters’ books, and the quarterly audit of the Bank of England’s circulation accounts to determine its allowance.” However, Funnell (1994) shows that this function was rather constrained and perfunctory.



Funnell (1994, p. 177) explains 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 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 organisational control.

From 1785-1832, audits became more widespread, but these audits were 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 and governance explanations. 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). Treasury decided which departments were to be audited (Funnell, 1994, p. 187).

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 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. It was also important as an organisational control function.

Meanwhile, in the private sector, the United Kingdom was experiencing rapid growth of joint stock companies. The companies continued to be audited by committees of shareholders, like earlier audits described by Watts and Zimmerman (1983). These audits were done without any legal compulsion, until various pieces of legislation were passed in the nineteenth century. Watts and Zimmerman (1983) argue that when legislation such as the UK Companies Act 1844 “Parliament was merely incorporating into the law a version of a practice that had existed for six hundred years” (Watts and Zimmerman 1983, p. 626). Various pieces of legislation modified the requirement for companies to have auditors, but without requiring the auditor to be a professional accountant (Watts and Zimmerman 1983, p.

628). However, by then most companies were appointing independent chartered accountants (Watts and Zimmerman 1983, p. 629). Watts and Zimmerman (1983, p. 630) attribute this trend to increasing complexity of accounts, increasing liability of directors, and the increasing size and number of companies.

Maltby (2009a, p. 227) observes that Watts and Zimmerman (1983) explains the persistence of auditing over a long period and its “invulnerability to its own failure”. Even when there are audit failures, auditing is still desirable. Maltby (2009a, p. 228) also criticises Watts and Zimmerman for not taking sufficient account of changes in society over the long period examined.

Independent auditing in the UK public sector was introduced at roughly the same time as independent auditing in the private sector. 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 Einzig (1959 p. 237). It also included appointment of a Comptroller and Auditor-General who was “entirely independent of the Executive and entirely in the service of Parliament.” 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 appointment 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”.

While it can be said that the audit function originated from the Magna Carta (1215) or from the Glorious Revolution of 1688 (Ferguson, 2001), these stories are about the principles and fundamental rights involved, and audit practice as we know it came later. There were auditors of a kind after 1688, although not immediately, but these functionaries appear to have been more equivalent to an internal control procedure, and may have been an out and out sinecure (Funnell 1994). An audit function as we now know it developed in the UK in the nineteenth century at about the same time as auditing of companies developed to something like what is now practised. It did not take its fully modern form with the appointment of an auditor responsible to Parliament and not under the control of the Treasury until 1866. The independent audit function is consistent with the agency and organisational control explanations for auditing.

In the late twentieth century, Power's view of the "Audit Society" and the "Audit Explosion" were very influential in the UK (Power 1994, 1997). They are sometimes discussed in other countries. Power's thesis was that private sector auditing had influenced the public sector, and led to an explosion of demands for reviews of activities in areas like health and education that were somewhat like audits. Reviews of public sector functions are more common, but this is not necessarily due to the influence of private sector auditing. Power was criticised by Maltby (2009b) for not recognising the long history of public sector auditing. Power (2000) himself suggested that there was a shortage of evidence that this explosion applied in other places apart from the UK.

The UK is a very influential source of New Zealand auditing laws and practices that relate to both the private and public sectors.

### **3.2 The development of public auditing in New Zealand**

New Zealand provides an interesting example of a country where public sector auditing is highly developed and where the extent of transparency is well regarded internationally. The development of New Zealand public sector was closely linked to the United Kingdom. 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 in the UK.

The development of public sector auditing in New Zealand is reviewed by Green and Singleton (2009). They show that, auditors existed from the start of the colonial period, in 1840 (Green and Singleton 2009, p. 11). Auditors were not independent and were subject to

the control of Treasury. In any case, the Governor had absolute power within New Zealand (Green and Singleton 2009, p. 12). However, the audit function was: “soon upgraded in status by the activist Governor George Grey, it underwent further change in an antipodean echo of the modernisation of public finances – and the British public service in general – that was driven by that colossus of the Victorian age, W. E. Gladstone” (Green and Singleton, 2009, p. 12).

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, and responsible to Parliament (Green and 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 and Singleton 2009, p. 11).<sup>11</sup> At this time, Parliament in NZ was in a strong position in comparison to the executive because political parties were yet to develop. The development of independent public sector auditing in New Zealand appears to be related to that in the UK, even if New Zealand legislation was slightly earlier.

Since then, public sector auditing has continued to develop. Suggestions for further change were made after 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 and 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). The judge in this case suggested that private sector auditors should be more involved in public sector auditing, and was supported by the Society of Accountants. Parliament and the accounting profession were not interested (Green and Singleton 2009, p. 82).

There was greater demand for change at the time of the public sector reforms of the 1980s. “Treasury’s main objective was to create a more efficient public sector, it tended to emphasise 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

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<sup>11</sup> New Zealand appears to have reached that stage earlier (1861) than Westminster did (1866). Green and Singleton note (2009, p. 26) that Auditor-General Fitzgerald (Controller and Auditor-General 1867-96) corresponded with British Prime Minister W.E. Gladstone.

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 and Singleton 2009, p. 128). Treasury’s view tended to concentrate on one agency relationship, between managers and Cabinet; while the Audit Office is more likely to include the relationship of Cabinet to Parliament (Pallot, 2003).

This difference is illustrated by the debate over the audits of state-owned enterprises (SOEs). According to Green and Singleton (2009, p. 128), some Treasury officials, the some SOE managers and some politicians preferred less detailed public disclosure and Parliamentary scrutiny of SOEs. Auditor-General Brian Tyler insisted on accountability to Parliament, and argued that Parliamentary accountability “should apply to all State-owned enterprises.” Treasury, and the SOE boards of directors, argued that boards should hire and fire their own auditors, as they then did in the private sector. They also argued that foreign creditors would have more confidence in well-known international audit firms. The Audit Office view prevailed in the legislation (Green and Singleton 2009, p. 127).

In the late 1980s the Audit Office was involved a controversy over a television advertisement. The advertisement showed how a change in taxation would affect a cleaner, later dubbed Mrs Mop. The opposition asked the Audit Office to investigate, and Tyler concluded that the advertisement was not objective and “threatened to cross the border between public information and propaganda” which should not be publicly funded. This criticism of government illustrates the independence of the Auditor-General, but “did not endear” Tyler and the Audit Office to government politicians, Treasury officials and SOE chief executives (Green and Singleton 2009, p. 128-129).

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 1987, Tyler proposed new legislation to make the Audit Office unambiguously accountable to Parliament, not the government. This change was eventually made, but not for some time. "These aspirations would not be fulfilled in their entirety until 2001” (Green and Singleton 2009, p. 130).

Instead, 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 and Singleton 2009, p. 130). The Auditor-General argued in response that “is recognised through 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).

Treasury were asked to review the situation and wrote a report supporting the continuing role of the Auditor-General but also suggesting a more restricted role for the Audit Office, and arguing for contestability of public audits (Green and Singleton 2009, p. 130). The Finance and Expenditure Committee of Parliament then recommended that the Audit Office be defined as an Office of Parliament and confirmed as statutory auditor of the entire public sector. However, this legislation was put off and not eventually passed until 2001 (Green and Singleton 2009, p. 131). Auditor-General Tyler “did not succeed in obtaining legislation to establish the Controller and Auditor-General as an Officer of Parliament. The relationship between the [Audit] Office, the executive and Parliament would continue to be poorly defined until 2001” (Green and Singleton 2009, p. 137).

Meanwhile, in the 1990s, the Audit Office went through a difficult period. It suffered substantial losses in a lawsuit, lost revenue due to public sector audits being made contestable by private sector auditors, and Auditor-General Jeff Chapman’s use of public funds for personal expenditure led to his being imprisoned for fraud.

First, the Audit Office was sued by Dairy Containers Limited for not detecting frauds by employees of Dairy Containers. In 1994 the High Court ruled that the Audit Office was 60% to blame and was required to pay \$8.778 million (Green and Singleton 2009, p. 145). The Audit Office was criticised in the judgment for not being reasonably competent (Ross 1995).

At this point (1994) the Audit Office was in “a financial mess” due to changes in the public sector, contestability, duplication of overheads between Audit New Zealand and the OAG, and the Dairy Containers liability (Green and Singleton 2009, p. 145). Although the government bailed the Audit Office out, Green and Singleton (2009, p. 146) suggest that this situation “presented the government with a golden opportunity to emasculate the Audit Office. That this opportunity was not taken suggests that most ministers still valued an independent public sector audit institution.”

More positive developments included the Office of the Auditor-General’s role in providing independent financial advice to Select Committees under a protocol of 1994 (Green

and Singleton 2009, p. 147). Eventually, new legislation (the Public Audit Act 2001) was passed – this had been delayed since proposals in the early 1990s.

According to Green and Singleton (2009, p. 152):

“This was very frustrating for the Audit Office but, in retrospect, the delay probably worked to the Office’s advantage. By 2000-1, the political and intellectual climate was more favourable to the Audit Office than it had been a few years earlier. The act gave the Audit Office more or less everything that it wanted.”

However, this did not occur until after there was “heated discussion” with Treasury officials, and later “Macdonald and the OAG began to solicit support from MPs” leading to an inquiry into Audit Office legislation (Green and Singleton, 2009, p. 152). The controversy arose over performance audits, and because Treasury wanted Parliament to have the authority to issue directions to the Auditor-General. Auditor-General David Macdonald threatened resignation over this point. The Parliamentary Finance and Expenditure Committee supported the Auditor-General and the legislation did not include the authority to direct the Auditor-General.

Under the 2001 legislation, the new audit legislation defines which entities are to be audited by the Auditor-General (Buchanan and Simpkins 2001). The Auditor-General publishes the auditing standards they will use in a report to Parliament at three-yearly intervals (Green and Singleton 2009, p. 153).

Performance auditing was also confirmed as part of the mandate of the Auditor-General (Green and Singleton, 2009, p. 153). It had developed since the 1980s and is sometimes associated with New Public Management (Power, 2000).

The consultation and communications over the Audit Act 2001 provide further evidence of the value of public audit.

In order for audit to be a signalling device, the Office of the Auditor General must be independent. This was confirmed, but also the Auditor-General was required to be accountable through submitting a draft annual plan to the Speaker and select committee for comments. The Auditor-General must also publish an independently audited annual report. David MacDonald, the incumbent Auditor-General, introduced the second reading of the Bill by stating that it “will enhance the accountability of government departments, local authorities and other Public Sector entities to Parliament and the public” (Office of the

Auditor General, 2001).<sup>12</sup> He further noted that the Reserve Bank was being brought under the Auditor-General's scrutiny for the first time as its financial auditor and therefore it is now able to review issues of probity, waste and legislative compliance of the Bank.

Many submissions and discussions surrounded who else was to be included in the mandate of the Auditor-General. The concept of 'control' was being tested in terms of who it was that government controlled and whether they therefore needed to be audited by the Auditor General. Discussion surrounded whether, for example, community trusts, NGOs, Maori Trust Boards, etc were to be included and what the Auditor-General's mandate should be over SOEs in respect to efficiency audits. It was agreed that independent scrutiny was a benefit of public audit but that requiring the Auditor-General to audit every entity with a 'public benefit' focus, would not only increase the workload of the Office, but also increase the number of exceptions in the Bill. The media picked up on parliamentary debate that such a change would make it seem that government was seeking to take these trusts' monies. The position was clarified when the Finance and Expenditure Committee (2000, para 4.12) stated "The Auditor-General should not ordinarily be expected to fill an accountability gap in relation to an NGO". Further, where mechanisms already existed for such entities to be audited, there seemed little need for the Auditor-General to also audit and (in respect of the TSB Bank Ltd which is controlled by the TSB Community Trust) "there are risks from inclusion to both the Crown through potential liability for the Bank's financial performance and the Bank through the effects of audit on depositor perceptions" (Treasury, 2001, p.6). This invokes the insurance hypothesis.

The Hon Jim Anderton, in introducing the third reading of the Bill, noted that "Parliament is granting to the Auditor-General a particular status that has a long history of integrity and impartiality. The Auditor-General will be expected to meet those standards, or the significance of the office will drop in the eyes of Parliament..." (NZPD, p.8675). The Hon. Bill English (then the Deputy Leader of the Opposition) agreed, noting that the Auditor-General must "act as a watchdog on behalf of the taxpayer, and to do so as effectively as possible". (NZPD p.8696).

In that respect, the submission by the Institute of Chartered Accountants of New Zealand (ICANZ) (2000, p.3) to the Finance and Expenditure Select Committee on the Public Audit

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<sup>12</sup> A number of submitters to the Finance and Expenditure Select Committee also stated this in their submissions, including ICANZ (dated 14 August 2000).



Bill stated that the audit standards used by the Auditor-General should be “developed and published independently of the Auditor-General” and recommended that the Bill should use their standards “as a minimum”. ICANZ also questioned whether a dedicated Audit Select Committee was needed (such as the Committee of Public Accounts in the UK and Joint Committee of Public Accounts and Audit in Australia). In the event, this suggestion was not taken up.

### **3.3 Recent developments**

More current developments include a peer Review (OAG, 2008) commissioned by the Auditor-General and including leading experts. The report referred to an issue over political advertising:

“The Office’s relationships with key stakeholders are in good shape overall. As noted earlier, recent stakeholder surveys bear out the high levels of satisfaction encountered by the Peer Review Team in their meetings with government agencies, local government and Parliamentary Select Committees. The one exception to this is the strain that has come into the Auditor-General’s relations with political parties as a result of the electoral advertising inquiry” (OAG, 2008, p. 21)

The peer review suggested a performance audit of Audit New Zealand:

Page 70: “It is suggested that consideration be given to having a performance audit undertaken of the Office by the External Auditor in the next year.

Response [by the OAG]: We are considering this suggestion and this proposal has also been passed on to our Audit and Risk Committee for their consideration. (The Auditor-General has agreed that all added assurance work undertaken by the auditor must have the Audit and Risk Committee’s support.)” (OAG, 2008, p. 70).

In 2011, an article in the *Chartered Accountants Journal*, about Auditor-General Lyn Provost, discussed regulation of auditing in the public sector compared to the private sector. An auditor under the 2001 Act can be an employee of the Auditor-General or a person or partnership qualified under the Companies Act 1993; they are not required to be a licensed auditor. The Auditor-General commented that “it would not be appropriate for a government agency, the Financial Markets Authority, to oversee a Parliamentary office, the OAG.” The OAG should not be regulated by those that we audit, she stated (*Chartered Accountants Journal*, 2011, p. 24).

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. The Auditor-General is an important constitutional function and old-established but not ancient, and has undergone

recent change (2001). The position of an independent auditor reporting to Parliament was established in the 1860s both in the Westminster Parliament and in New Zealand. Continuing development since then has included changes in response to reforms in the New Zealand public sector in the 1980s and 1990s, especially in the legislation of 2001. There are continuing changes in the environment outside public auditing, including independent regulation and stronger governance within the entities being audited.

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 historically there has been stronger demand for auditing from the principal than from the agent. The parallel development of private sector company auditing, for agency reasons, also appears to have been influential. The signalling 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 organisational control has been very important in the development of public sector auditing, and it also appears to contribute to risk management and governance. The role of auditing in confirmation of previous unaudited announcements could be important, but has not been investigated.

### **3.4 Discussion of issues**

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 important in explaining the value of auditing, and these are more complicated in the public sector. These explanations apply in both the private sector and the public sector. They tend to show that auditing is beneficial to the managers of the entities being audited. Especially in the private sector, auditing has evolved as a useful part of business entities without the need to be imposed by law. 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 corporate governance 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, auditing is beneficial to the economy and society generally. There are variations in the ways in which auditing is practised and regulated around the world, and changes over time. The confirmation hypothesis, where auditing of historic financial information is important

because it confirms the reliability of earlier unaudited announcements is likely to be helpful in understanding auditing.

Recent changes in auditing around the world include the move to independent regulations, including independent standard setting and inspection. Auditors issuing opinions on internal control is now accepted as part of the audit of listed companies in some countries (although not New Zealand). Other forms of assurance are also widespread, although not usually compulsory, for example auditing of sustainability reporting, or privacy auditing.

## Chapter 4: Issues for further investigation

Reviewing research about the value of auditing shows a number of ways in which the value of public auditing becomes clear. This section reviews current developments in auditing and question that they might raise for the value of public audit in New Zealand. It also raises some questions for further investigation.

1. Corporate governance in the New Zealand public sector  
Over the period since the Public Audit Act 2001, corporate governance practices in the private sector and public sector around the world have developed considerably. Stronger corporate governance through independent directors and audit committees appears to be associated with greater demand for independent auditing. To what extent is corporate governance of New Zealand public sector entities consistent with the guidelines published by the Financial Markets Authority (2014)<sup>13</sup>, or international best practice? There is recent work by the OAG on this issue.
2. Internal audit  
Internal auditors can also be an important part of corporate governance. How widespread is internal auditing in the public sector?
3. Reporting on internal control  
Management letters or other documents making recommendations on internal control are already produced by public sector auditors. There could be considerable value in (a) making these existing reports available; and (b) auditors issuing opinions on the effectiveness of internal control along the lines of those required for large listed companies in the United States. Public reporting of internal control weaknesses might encourage entities to improve their internal control. It might also increase the perceived value of auditing. Is it feasible and useful for New Zealand public sector auditors to report publicly on internal control?
4. Unaudited announcements and confirmation of previous announcements  
If the audited financial statements serve a function of confirmation of earlier unaudited announcements, then auditors ought to be aware of the unaudited announcements and take note if whether they are consistent with the audited results that are announced later. To what extent are unaudited announcements of financial or other information made by public sector entities? Are these subsequently confirmed by audited information?

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<sup>13</sup> The Guidelines state: “Not all of the principles will apply entirely to all entities. We encourage entities to consider the nature and needs of their businesses when considering how the principles apply to them. Public sector organisations, for instance, do not have shareholders in the traditional sense, and are subject to specific board appointment processes. However, they have an owner and are accountable to that owner, as well as to other stakeholders and the public. These entities should observe the principles to the fullest extent they reasonably can, except where they are subject to competing statutory or public policy requirements.”

5. Reasons for auditing in audit planning  
Various explanations for auditing for example agency, signalling or corporate governance issues are important in assessing audit risk and in deciding what is material. To what extent do public sector auditors take account of these issues in their planning?
6. Oversight of public sector auditing in New Zealand  
Recent developments in New Zealand, and around the world, including independent oversight bodies who inspect some audits and report publicly on the standard of auditing. Different issues arise for audits carried out by private audit firms and those conducted by Audit New Zealand. How should there be independent inspection of public sector auditing?<sup>14</sup>
7. Setting of standards for public sector auditing  
Recent developments also include independent setting of audit standards. Should auditing standards be set independently from the Office of the Auditor-General? At present the International Standards on Auditing are adopted with an overlay of public sector standards.
8. Other types of assurance  
Auditors are becoming involved in wider areas of assurance services. Should the Auditor-General also report on sustainability assurance, or privacy auditing, or assurance on other issues?

Consideration of those issues might lead to further changes in the function of the Office of the Auditor-General of New Zealand in each of those eight areas. Investigations 2 and 3 gather more information on these issues internationally and in New Zealand.

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<sup>14</sup> We understand that inspections will be conducted by the New Zealand Practice Review Unit of Chartered Accountants Australia New Zealand and also by the Financial Markets Authority, in addition to the quality assurance functions of the OAG and those within the audit firms.

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