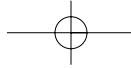

Auditing The Third Way: A Review of the Developing Role of Public Sector Audit and Inspection

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Abstract

This paper presents a picture of current issues pertaining to audit in the public sector. It explores the outcomes of the political ideology termed the 'Third Way' on the role and nature of public sector audit. It initially considers the Third Way and its core philosophies and policies and the implications of these for working relationships within the public sector. It identifies that within its strategy for the implementation of the Third Way that the UK Government has specified a key role for audit in ensuring both performance measurement and accountability. Finally, it explores the challenges that these roles present for the public sector auditor and suggests some potential ways forward including areas for further research.

Introduction

Since the General Election of 1997 the New Labour Government has followed an approach to the management of the public sector which has been christened the 'Third Way'. It embodies a political ideology which is beyond the old left of the 1950s and the new right ideals of the 1980s. It is many things to many people but Milliband (1999) describes it as follows:

- Growing interdependence resulting in a return to collective solutions to problems but with a new role for the state as a facilitator and enabler.
- Low paid jobs are better than no jobs but that there should be a minimum wage and those on low wages who support families should be assisted.
- The development of civil rights and responsibilities.
- Social inequalities can be countered through public policy.
- Globalisation demands the reform of international institutions to meet the demands of a more interconnected world.

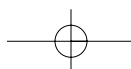
Critically for those operating in the public sector a core theme of the Third Way is the need to promote democracy that embraces openness and accountability as well as modernising public services. Modernisation includes a new focus on outcomes for the citizen as compared to the input-focused management of the 1980s that focused on the service provider. As Jones and Stewart (1999) state, "Ends are more important than means, which makes structures and processes less important."

It leads to a redefinition of the relationship between central government and other sections of the public sector as follows:

- Defining rigorous and challenging national standards.
- Encouraging the development of continuous improvement through performance frameworks.
- Consultation with the public and collection of stakeholders' opinions.
- Incentives for those public sector organisations which achieve continuous improvement.
- Penalties and 'zero tolerance' of failure, the potential for the withdrawal of service delivery privileges.

These ideals have been embodied in legislation requiring the public sector to recognise to drive for the continuous improvement of the delivery of public services. For example, the Local Government Act 1999 introduced the requirement for local authorities in England and Wales to pursue best value and introduced a new dimension to the inspection of local authority services, where a review of the authorities best value plan and the continuous improvement of services fell upon the Audit Commission's Best Value Inspectorate.

A further challenge within the modernisation agenda is 'joined up' service provision and an emphasis on e-government. The former refers to the aim of central government for the public sector to present a seamless face to its customers, breaking down traditional departmental and



organisational boundaries and encouraging co-operation between entities which have been perceived as secretive and guarded. This again emphasises the core theme of the Third Way for public services to meet the needs of the public and not of the public service providers.

The modernisation agenda addresses all aspects of local government, including the move away from the traditional committee system to one of cabinet style governance with an option for elected mayors. For those working in the public sector this means potentially substantial changes in the relationships between officers and members.

In Wales and Scotland the introduction of devolved government in the form of the National Assembly for Wales and the Scottish Parliament means that the modernisation agenda is being implemented against the backdrop of a new and unique form of devolved government. This presents the opportunity to develop a tailored approach to modernisation in these regions which recognises the differing structures and cultures of their public sectors.

The Role of Audit in the Third Way

Whilst there is still academic debate over the extent, nature, practice and concept of public audit (Power 1994, Lovell 1996 and 1998, Evans 1998), the UK Government sees a central role for both internal and external auditors in the implementation of the Third Way.

Both sets of auditors have a key role to play in the development and monitoring of the performance frameworks and plans and ensuring that public accountability and value for money are maintained. The role of the external auditor is prescribed in the Best Value (Local Government Act 1999) legislation in terms of the audit of performance plans and their achievement. However, this role is not a static one and continues to develop.

An example of a regional, tailored approach of a changing role for auditors and inspectors is the Wales Programme for Improvement. This has been developed by the Welsh Assembly Government in conjunction with the Welsh Local Government Association and representatives of public sector auditors and inspectors in Wales and is an approach to best value which recognises the specific structure and nature of local government in Wales. One of the key elements of the Wales Programme for Improvement is the publication of a 'Regulatory Plan'. The purpose of the plan is to present a clear picture of the level of regulatory activity which a local authority can expect in the forthcoming year and to ensure that the level of audit and inspection is 'both proportionate and manageable from the point of view of the authority's own capacity to manage change.' (Wales Programme for Improvement: Guidance for Local Authorities, National Assembly for Wales, 2002, p.21)

In this context, the Audit Commission's lead Manager for Wales, Andrew Wood has stated, 'I am keen to develop a far more integrated approach to audit and inspection...(to) demonstrate our commitment to a more collaborative and inclusive approach to the audit and inspection'. (Wood, 2001)

Auditors, by operating in new governance frameworks both within local government and the new regional government systems, may also become more directly accountable to the public as they take up a high profile position in the implementation of the Third Way. This commitment to open government could mean auditors finding themselves closer to the public as well as the service deliverers whom they audit. Also they may find that the development of tailored approaches will be required. The Audit Commission's second annual statement on Best Value, 'Changing Gear', states that 'both audit and inspection need to be reshaped to provide challenge and external review that is more focused on the needs of different councils'. (Brown, 2001)

There is growing recognition that public sector auditors need a modernised, joined-up approach to a modernised, joined-up public sector. The Public Audit Forum was created in 1997 following a recommendation of the White Paper, *The Governance of Public Bodies: A Progress Report*. Its membership includes representatives from the four 'public audit' bodies, the National Audit Office (NAO), the Audit Commission (AC), the Northern Ireland Audit Office (NAIO) and the Accounts Commission for Scotland. However, it also includes as members of its Consultative Forum key representatives from the audit process and members of the accountancy profession.

The Forum has published what it sees as the implications for public audit of the Better Government agenda. It has described the auditor's challenge as the need for auditors to recognise that public sector managers are being encouraged to be far more innovative and imitate their private sector equivalents by becoming risk takers. However the public sector audit process is historically averse to this concept. The issue that different parts of the public sector in the joined up system of government come under different audit regimes complicates this (Evans and Thornton, 1997).

In response to the challenge the Public Audit Forum has identified the following issues:

- The need for new forms of accountability;
- The readiness of auditors, as well as managers, to embrace change;
- The challenge of assessing value for money where more than one body is involved;
- The importance of performance measurement;
- The need for financial discipline and to ensure the legality of expenditure;
- The importance of co-operative working between auditors.

On the basis of these proposals Martin Evans of the Audit Commission concludes,

"Far from being a problem, public audit can play an important role in the development of high quality, more efficient and effective, and more accountable public services." (Evans, 1999)

Each of these issues is now considered against the backdrop of the Third Way.

The need for new forms of accountability

The ending of the traditional committee system in local government and the potential need for the co-ordination of effort between internal and external auditors and inspectors means that new forms of accountability within the local government structure will need to be established. This would seem to be a classic role for an audit committee and indeed the Audit Commission (1996) identified many benefits and potential improvements in governance through the operation of an audit committee.

However, evidence collected by Davies and James (1999a) suggested that while internal auditors felt that many benefits could be obtained by the establishment of an audit committee, in practice few authorities in Wales had taken the step and continued to deal with audit issues through the traditional committee structure. On going research by Davies and James (1999b) on the role of audit committees in local government revealed that the establishment of audit committees is rising up the governance agenda but that the role and scope of these committees still varies considerably.

It is interesting to follow the developments in local authorities as they begin to experiment with the cabinet style of governance. The statutory establishment of the scrutiny committee has taken precedence over the establishment of an audit committee, which some local authorities consider to be adequate, others however have taken on board the merits of an audit committee and have established one in its own right.

In its policy statement 'Freedom and Responsibility in Local Government' (Welsh Assembly Government, p.37, 2002) the Welsh Assembly Government notes that Guidance on Executive

Arrangements urges local authorities to set up audit committees which do not contain members of the Executive and Board but which contain independent non-councillors. This is in a similar vein to the Cadbury recommendation for audit committee membership of non executive members. The policy statement also states that the Welsh Assembly Government will work with local government to explore ways of making audit committees as effective as possible.

Davies and James (1999a) also identified that trends for 'down-sizing' within local government, under pressures to achieve value for money, had meant that in many cases the Chief Financial Officer had been downgraded to a second and sometimes even a third tier post. The resultant effect being a loss of position and status for the internal audit function. This may have serious implications for the role which internal audit can play in the preparation and monitoring of performance plans.

The Audit Commission (1998) has also expressed concern over the erosion of the status attached to the director of finance and thus it may be inferred internal audit. The creation of audit committees may be a way of improving the position of internal audit within the governance framework. In addition, the Turnbull Report (1999) firmly established the importance of internal control review as an integral part of corporate governance, which elevated the role of the internal auditor. The Turnbull Guidance IIA (UK) (1999) identified 'a greater emphasis on objective assurance obtained from internal audit'. The impending adoption of the Turnbull recommendations by local authorities may serve to further raise the profile of internal audit. However, internal auditors will need to demonstrate that they have the skills to actively participate and make valid contributions to organisational effectiveness.

Internal audit seems to be embracing these changes. Davies (2001) recognised the changing face of internal audit in that 'there has been a progression from the traditional minimum audit service as required by statute to the more corporate approach of business assurance provider'.

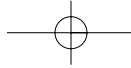
The readiness of auditors, as well as, managers to embrace change

The management of change in the public sector in the UK has become an area of disagreement between the UK Government and other parts of the public sector. The Prime Minister declared his frustrations at the refusal of the public sector to change. Inevitably this raised a storm of criticism centred on the argument that the public sector has done nothing but change and change substantially since 1979.

This led to the Deputy Prime Minister stating that, "The public sector makes a better life for everyone" and that partnership between central and local government was essential to achieve this (Pinder, 1999). In reality, parts of the public sector has managed change well as evidence from Pettigrew et al. (1992) provides plentiful examples of successful change management in the National Health Service.

Likewise, Farnham and Horton (1995) identify a major cultural shift in the public sector away from traditional public service values to a culture dominated by markets and managerialism. They present an excellent assessment of the public sector changes which have occurred since 1979. Both Farnham and Horton and Keen and Murphy (1996) suggest that these changes may well be a twin-edged sword. For example, Keen and Murphy quote Grey and Jenkins (1993) positive arguments in terms of promoting better performance and greater accountability whilst identifying Hood's (1991) counter argument that it has increased middle-level bureaucratisation at the expense of the front line.

Despite strong academic arguments against the wholesale application of private sector type markets and management practices in the public sector (Ranson and Stewart, 1988, 1989), the public sector, driven by a demanding policy agenda, has had little choice but to change. However, given the complexities of



individuals, organisations and change, it is impossible to draw broad generalisations or develop 'models' for the successful implementation of change or even identify generic evaluation criteria.

However, there is little doubt that the implementation of the Third Way will lead to more change. In the financial sphere, the Audit Commission (1999) identified that the existing planning and financial systems within local government are inadequate to support full-blown Best Value. The study identifies the systems to be short-term based, incremental and lacking in public consultation.

As part of the implementation of the Wales Programme for Improvement, the Welsh Assembly Government has also noted that it will be important for the financial and performance management systems of local authorities to be integrated and seamless. 'The systems for managing an authority's performance and finance play an integral part in the approach to corporate risk assessment. Scrutiny committees and audit committees will have a key role to play in this process.' (Freedom and Responsibility in Local Government, Welsh Assembly Government, 2002, p.62)

The reform of these systems will present interesting challenges for the public sector auditor who could play a vital part in ensuring their robust design and implementation. The Public Audit Forum consultation paper, 'Propriety and audit in the public sector' (May 2000), provides guidance aimed primarily at external auditors and senior management, however, Wynn (2000) considers it to be useful guidance for internal auditors as it provides discussion on basic concepts including accountability, governance and internal control. This could be interpreted as generating an increase in the consultancy function of internal audit if it becomes more involved with governance and accountability as the way forward then it will need to be carefully managed within organisations as so as to ensure their continued independence.

The challenge of assessing value for money where more than one body is involved

The 'hollowing out' of the state (Rhodes, 1994) has meant that increasingly in the public sector reliance is placed on the delivery of services by what have been termed 'networks' (Rhodes, 1996, Hoggett, 1996, Kickert, 1995, Taylor, 1997). These are networks of service providers delivering services at 'arms length' from central government but in many cases not outside its direction.

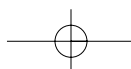
The former Department of the Environment, Transport and the Regions' Local Government Research Programme into cross cutting issues (DETR, 1999) recognised that there are long standing blockages to effective integrated working. The long standing tension within central-local government relations, the impact of new contract forms of service delivery and the role of professionalism in maintaining vertical working, to name but a few.

The above study identified that a major difficulty for the successful operation of multi-agency teams was that there was no definitive definition of the problem or the desired outcomes. There was little agreement about cause and effect and therefore which measures might be the most effective. These can lead to major difficulties in terms of the evaluation of service delivery.

As Eilbeck and Bingham (1999) identify performance measurement in this sense may become public sector audit's own 'wicked issue'. This may not be an easy nettle to grasp given the difficulties identified below in terms of co-operation amongst auditors.

The importance of performance measurement

The role of the auditor in assessing performance came to the fore with the publication of the Citizen's Charter in 1991. The Local Government Act 1992 provided a statutory basis for the Audit Commission to audit and publish information to facilitate the comparison of local authorities against each other and over time.



Reservations were expressed with regard to the usefulness of the charter itself (Pollitt, 1994) and at the wisdom of handing over the design and collection of the information to external auditors (Bowerman, 1995). Arguably, this early data was limited and whilst intended to measure value for money focused in the main on economy and efficiency, the traditional strength of professionals trained in the area of accountancy. However, the bias towards results orientated government has led towards a focus on outcomes and the rise of effectiveness as the most prominent 'e'. Power (1995) identifies that it is in this domain that traditional auditors from financial background feel most exposed.

The Quinquennial Financial Management and Policy Review of the Audit Commission (DETR, 1998) identifies this skills gap as one which the Audit Commission must urgently address. It recognises that this will present a particular challenge within tight resource constraints and at the same time maintaining the independence of the Commission.

Inspectorates in some areas of the public services, such as education and social services, are well established and the Audit Commission is starting to build relationships with these organisations in recognition that auditing outcomes extends beyond its traditional skill base. Although Travers (1998) identifies that some of these working relationships are more successful than others. Travers identifies that clashes of cultures exist between the evidence based method of working of the Audit Commission and the judgmental based method of inspectorates, particularly OFSTED in England. Travers also identifies that there is a difference in the independence status of inspectorates and the Audit Commission. The Commission is financially independent and has a reputation for critical reporting of government activities while inspectorates on the other hand generally look to sponsoring departments for guidance about priorities.

Eilbeck and Bingham (1999) identify that there is a role for the Public Audit Forum in defining and developing working practices. This should include the development of training programmes to ensure skills are developed beyond the traditional areas of financial accountability. There will be an important role for organisations such as the Wales Inspectorate Forum and its regional equivalents in the sharing and development of best practice.

Particular care will need to be taken for the development of services in the joined-up domain because as Williamson (1999) identifies there is a real danger that the targets set for individual service providers will work against them carrying out joint projects. Public auditors will need to pay particular attention to the coherence of performance measurement in these areas and could have a vital role to play in identifying any such dysfunctions.

The need for financial discipline and to ensure the legality of expenditure

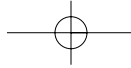
This sounds like firm ground for auditors, the traditional function of traditional public sector audit. However, with the introduction of so much change and new resource allocation functions associated with the introduction of regional government in parts of the UK, this is a complex issue.

Auditors will be treading new ground and untested waters. New structures for partnerships, joint committees and boards present complex issues of governance and financial accountability.

The importance of co-operative working between auditors

Bowerman (1994) identified several areas where the work of the NAO and the Audit Commission interfaced. Both examined value for money in the National Health Service and both had an interest in local services largely funded by central government.

She concluded that co-operation between the NAO and the AC was not close in all the areas in which they interfaced. It was identified that activities were co-ordinated to the extent that the organisations ensured that they did not simultaneously examine the same aspect of a topic but



that there was no active planning to ensure rounded coverage of topics across the whole of the public sector.

Travers (1998) when commenting on the Sharman Report felt that it did nothing to tackle perceived overload of audit and inspection in the public sector. Although the concept of working together was recognised, the Sharman Report does not provide any practical advice on how to achieve this co-operative working relationship.

A number of recent developments however offer potential ways forward. As previously noted, in the Wales Programme for Improvement a Regulatory Plan will be produced which will take account of the level of audit and inspection in any one year for an individual authority with the aim of maintaining it at a level manageable for that authority. In a letter to Local Government Chronicle (LGC, 1/3/02, p.9) Sandy Blair, Director of the Welsh Local Government Association suggests that in Wales this results in 'no ironic over-layer of inspection here.'

Also in the announcement of the creation of the Commission for Healthcare Audit and Inspection (CHAI) and the Commission for Social Care Inspection (in England) in the 2002 Budget introduces wide ranging changes to the structure of inspection in these areas intended to bring greater co-ordination (Ward, 2002, p.21). CHAI brings together the work of the Commission for Health improvement with the Audit Commission's value for money work in the health service. CHAI will also be responsible for the inspection of private hospitals, taking over this work from the National Care Standards Commission which will be abolished. The Commission for Social Care Inspection will take on the balance of work from the National Care Standards Commission and the Social Service Inspectorate.

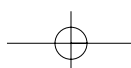
In terms of the creation of a single public sector audit body, Bowerman (1994, p.60) concluded that the benefits of competition, for example, innovations in methodology outweighed the potential benefits of merging to form one public sector audit body, particularly as the "area where an integrated approach is required is relatively small."

This was supported by the DETR's Quinquennial Financial Management and Policy Review of the Audit Commission (1998) which recommended no major changes to the Commission's role and remit. The review, however, did recognise that the area identified by Bowerman had still not been resolved and recommended 'a further attempt should be made to define and demonstrate more clearly the respective responsibilities of the NAO and the Audit Commission in relation to the NHS in particular' (Para. 10.15). As noted above the work of the Audit Commission in relation to health service value for money studies will now be moved to CHAI.

Travers (1998) also identified that each of the organisations was determined to maintain its independence and that the working relationship between the Audit Commission and the National Audit Office has never been anything other than 'a slightly tense professional relationship'. This is because of the different histories and accountabilities of the organisations and in some instances the competition for audited bodies.

In the regions the debate has moved on, the National Assembly for Wales has approved proposals for an 'Audit (Wales) Bill' which will create a single audit body for Wales (LGC, 5/4/02, p.4, LGC, 12/4/02, p.11).

The creation of the Public Audit Forum is in itself an attempt to co-ordinate and standardise audit effort across the public sector, including providing strategic focus on cross-cutting issues. This is the first step towards addressing the concerns raised by Bowerman and also arguably concerns which have increased in importance with the advent of services delivered by hollowed-out networks



of public service providers. Co-operation amongst auditors is no longer just desirable, it is essential to ensure that the networks are accountable for their service delivery.

But co-operation is essential not only to ensure the above but also to ensure that audit overload does not occur. Classic work by Day and Klein (1990) in the area of social services identified the concept of 'inspectorial overload'. This is supported by Travers (1998) who argues that few of the inspectors take into account the financial costs and stress of their 'victims' when assessing the costs and benefits of their own activities. The kind of co-operation identified by Bowerman (1994) may prevent four sets of auditors turning up at the same time to audit the same aspect of service delivery but it does not, in theory, prevent them from turning up on consecutive weeks to do just that.

Limited numbers of joint reports to date from the public audit bodies suggests that whilst there may now be a willingness to co-operate, practice lags some way behind.

Evidence from the Healthcare Financial Management Association (1998) also suggests that co-operation between internal and external auditors could be improved. This was cited as one reason for the failure of the National Health Service to successfully combat rising levels of fraud. Another interesting aspect of this evidence is that there is a greater preponderance of private sector audit firms providing an internal audit function in the health service than elsewhere in the public sector. It would also seem that the audit interface between both public sector based and private sector based auditors needs developing. It is difficult to see how this will develop in the short term given the post-Enron lack of confidence in the private sector audit regime.

Likewise Levy (1994) identified that there seemed to be little contact and no joint activities between the European Court of Auditors and the National Audit Office. Whilst it must be recognised that both organisations have moved on since the research was conducted. The increased level of public service funding by the European Union in the UK, and the increase of fraud within the European member states in relation to EU funds has led to the roles of both auditors moving towards a more effective working relationship.

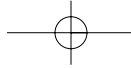
Conclusions

There are no easy answers to any of the above issues. Changing attitudes and cultures takes time. Whilst individual agencies may have clear strategies arguably there may be a lack of strategic audit focus across the public sector.

Clearly, the creation of the Public Audit Forum is a step in the right direction and it will have an important role to play in the development of a joined up approach to public sector audit, its publications are designed to provide a service as guidance to auditors and management. A priority should be the sharing of best practice and the development of a common approach and understanding. It is important that its discussions and policies are turned into action.

As noted above, the changing of cultures and working practices is never easy but initiatives such as joint training programmes and work exchanges might assist in the creation of an organisation wide commitment to joined up audit.

Any initiatives in the audit domain should be extended beyond the four organisations of the Public Audit Forum into private sector firms and internal audit functions within public sector service providers. Obviously, it will be important to maintain independence for the traditional external audit function of final accounts audit but it should be possible to maintain independence and still benefit from the cross fertilisation of ideas and opportunities which the above joint initiatives present. This is an area where at an organisational level the audit committee structure can help develop



co-operation, planning and dissemination of experiences between auditors and inspectors. The Wales Inspectorate Forum and its equivalents can replicate this at a national level.

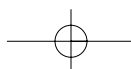
It is arguably now an opportune time to move on from the Sharman Report and capitalise upon the growing recognition of the opportunities for a co-operative working approach for public sector auditors and inspectors.

Training will be essential to develop skills in the evaluation of effectiveness; the above initiatives will need to include specialists from outside the traditional audit sphere. Davies (2001) research results from interviewing internal auditors found that 'Both staff and audit managers agreed that there was a need for more staff training. One of the key drawbacks identified was that of financing and resource reallocation'. This skills gap is not limited to auditors as it is also a key issue for the membership of audit committees and is worthy of further research and consideration.

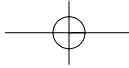
The public sector, including its auditors, has shown itself to be capable of managing change, the concept of joined up audit is achievable, it just needs perseverance. This area of joined-up audit and the challenge of change is a platform for further research where the progress and impact of these developments can be reviewed and monitored both in terms of the public sector and its auditors. However an important aspect that must not be lost sight of during this period of change and development is the traditional audit role of financial accountability and legality of expenditure.

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