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# Municipal Audit

-The Switch of Audit Firm-

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## Abstract

- Title:** Municipal Audit - The Switch of Audit Firm
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- Authors:** Josefine Holmqvist, Mattias Karlsson, Linda Norrman
- Advisor:** Torbjörn Tagesson
- Key words:** Municipal audit, Procurement process, Switch of audit firm, Professional auditors, Trustee auditors
- Purpose:** The aim of this master thesis is to create a better understanding for what factors that affect a switch of professional audit firm in the municipal sector in Sweden.
- Methodology:** In order to achieve the purpose of this thesis, we adopted an abductive approach and a qualitative method was used.
- Theoretical perspectives:** The theoretical framework includes theories and previous research about factors that may have an impact on the switch of audit firm. Most previous researches are conducted- and the theories are applied in the private sector and in the municipal sector in foreign countries.
- Empirical foundation:** The empirical foundation is based on one survey and twelve interviews with respondents from three municipalities.
- Conclusion:** Based on the empirical data, we have found four factors that affect the switch of professional audit firm in the municipal sector in Sweden. These factors are: audit fee, commitment, independence of the professional auditor and audit quality.

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# **1 Introduction**

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*This chapter gives the reader an introduction to the chosen subject. The following sections will give a background and a discussion about the audit in municipalities. This will culminate into the research question and the aim of this thesis. Finally, the disposition of the thesis is presented.*

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## **1.1 Background**

The municipalities in Sweden are responsible for the social services such as elderly care, education and childcare (SKL, 2010b). These functions are to 70 percent financed by the revenues from the municipal tax (SKL, 2010b). There are 290 primary municipalities in Sweden (SCB, 2010) and the municipal sector has a yearly turnover of approximately 500 billion SEK. According to Cassel (2000), there is a widespread dissatisfaction among the population in Sweden where the citizens sometimes seem to be sceptical about the local politicians not using the tax money appropriate. Cassel (2000) refers to a study made by Svenska institutet för opinionsundersökningar (Sifo) in 1999 where 90 percent of the Swedish population had little or no confidence in their politicians. Questions often arise whether or not the resources are properly allocated. In order to gain trust and to overcome this scepticism among the population, the trustee auditors in municipalities perform an audit to review that tax money is spent correctly. (Cassel, 2000; Lundgren, 2008)

The politicians in municipalities have a responsibility towards the citizens that the tax money is spent as efficiently as possible. Trust of the legal system is hence essential; citizens must feel comfortable of the politicians' and the trustee auditors' work. (SKL, 2008a) Within each municipality there shall therefore be professional auditors as experts to assist the municipal audit board. The professional auditors shall on behalf of the municipal audit board review the municipal boards and examine how the trustees and the employees fulfil their mandate (Törnvall et al., 2008). To be able to carry out the assignment in a proper way and to add professional knowledge to the audit process,

the professional auditors must have the required experience of local government operations. (Cassel, 2000; Municipal Act)

The laws of the audit process in municipalities are regulated in the Municipal Act. The greatest difference from the private sector is that the trustee auditor in the municipality is not a professional auditor, instead the auditor is elected and an active politician. The review is therefore not made from an independent position since the trustee auditor is party-politician. (Cassel, 2000) The public sector also has a softer regulation than the private sector and this puts less demand on the audit process. There is for example no link between the municipal law and the penal code. (Blank et al., 2009; Falkman et al., 2008; Rubin, 1988)

There are four large audit firms in the Swedish market, PricewaterhouseCoopers (PwC), Ernst & Young, KPMG and Deloitte, which are called the Big Four (Chang et al., 2008). In Sweden, PwC:s department Komrev is the largest actor when it comes to audit in the municipal sector. Komrev is although exposed to competition from other audit firms that have entered the municipal sector. (Blank, 2006) Some of the municipalities have their own internal audit department with auditors who review the municipal operations and examine how the trustees fulfil its mandate. However, it is most common that municipalities hire professional auditors as experts. (Svenska Kommunförbundet et al., 2001; Cassel, 2000)

The audit performed by professional auditors is procured, inspected and exposed for competition. The procurement is rather complicated and there are high demands on the people concerned in the municipal audit board to produce a mission statement, specification of requirements and an evaluation to make an efficient procurement. (Svenska Kommunförbundet et al., 2001) The trustee auditors shall examine and consider whether the activities is managed efficiently and economically from a satisfactory manner, if the accounts are true and if the internal controls that are within the committee are adequate (Municipal Act). The trustee auditors shall, in their report give recommendation whether municipal council should grant or reject freedom of liability to the municipal boards (Lundin, 1999).

## **1.2 Discussion of the subject**

To achieve high audit quality and at the same time keeping the cost as low as possible, municipalities need to make choices (Lundgren, 2008; SKL, 2010a). To make sure that the municipalities' financial statements are reviewed in a satisfying way, a careful procurement process of a professional audit firm must take place. The process starts with the formulation of a procurement document, which states the qualifications that are needed from the professional auditors. The trustee auditors bear the ultimate responsibility of the audit and the professional auditors perform the audit on behalf of the trustee auditor's mission statement. How long the contract period extend, differ between 2-4 years with the possibility of an extension of 1-2 years. It is the trustee auditors who make the procurement of the professional audit firm. (Svenska Kommunförbundet et al., 2001; SKL 2008a)

The procurement process is regulated in two different laws, the Law of Governmental Procurement and the Municipal Law. The Law of Governmental Procurement states that municipalities shall choose between the lowest price or the economical most favourable actor. The Municipal Law states that the professional auditor must be independent and have specific knowledge of the municipal environment. The audit in the municipal sector shall be both cost effective and still hold same high quality as in the private sector (Cassel, 2000; Lundgren, 2008).

Since the procurement process is a substantial part of how professional audit firms are selected, it is relevant to have knowledge of how such a process works since the switch from one professional audit firm to another is performed through a procurement process. Previous research conducted in the private sector show that price is an essential factor when switching audit firm. (Gómez-Aguilar et al., 2003; Hudaib et al., 2005). Previous research in the municipal sector has proved that quality rather than price is the considerable factor (Johnsen et al., 2004). This is confirmed by the guidelines about procurement that SKL (2008a) presents, where the qualifications of the professional audit firm is crucial. Even if there are guidelines by Sveriges Kommuner och Landsting (SKL), and regulation in the Municipal Law and the Law of Governmental, procurement is although a complex assignment for the trustee auditors. The difficulty derives from which criterions that should be considered when selecting or switching professional audit firm.

We have not found any research regarding the change of professional audit firms in the Swedish municipal sector and it seems to be a gap of knowledge. What criteria that is essential when selecting or switching professional audit firm can be seen as confusing, therefore we find the need to clarify this further. This study may also contribute to a higher understanding of the procurement process since this is a part of the switch of professional audit firm. With this background and discussion of the chosen subject the research question and the aim of the thesis is presented below.

### **1.3 Research question**

Why do municipalities switch professional audit firm?

### **1.4 The aim of the master thesis**

The aim of this master thesis is to create a better understanding for what factors and why these factors affect a switch of professional audit firm in the municipal sector in Sweden.

## **1.5 Disposition**

### **1. Introduction**

Background of the chosen subject is presented, followed by the research question and the aim of the thesis.

### **2. Methodology**

Research approach and choice of theory is presented.

### **3. Municipal audit and the procurement process**

The function of the municipal audit is presented followed by an explanation of the procurement process. Finally, the interviewed professions are presented.

### **4. Theoretical Framework**

Chosen theories and previous research are presented, which will be the foundation for the analysis.

### **5. Empirical methodology**

This chapter will describe the procedures in the collecting of the empirical investigation and also how the collected empirics will be analysed.

### **6. Analysis of the empirical results**

The empirical results will be presented and analyzed with help from the theoretical framework.

### **7. Conclusion**

The research question is answered followed by theoretical contribution, observations and reflections criticism of the study and a presentation of further research.

## **2 Methodology**

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*In this chapter the reader will be presented to the aim of this thesis and the research approach which will be followed by choice of theory.*

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### **2.1 The aim**

The aim of this master thesis is to create a better understanding for what factors and why these factors affect a switch of professional audit firm in the municipal sector in Sweden. This is performed by exploring the reasons to why a municipality switches professional audit firm. We have not found any previous research in this empirical area in the municipal sector in Sweden, therefore the phenomenon will be viewed in a new way (Saunders, 2009) since we do not believe that previous research conducted in the municipal sector in foreign countries or in the private sector is completely applicable in the municipal sector in Sweden. This since it mainly focuses on financial audit and the main focus in Swedish municipalities is foremost managerial audit (Johnsen et al., 2004b).

### **2.2 Research approach**

With the aim of this thesis and the research question in mind, we do not solely find the deductive approach suitable for this study. This since the research question cannot be answered by only testing theories against the empirical results, which the deductive approach is characterized of. We do not either solely find the inductive approach suitable where theory is generated from the empirical results. Instead, we shift between the deductive- and the inductive approach which leads us to the abductive approach. (Bryman et al., 2005) This means that we have some insight in theory but we are nevertheless in need of empirical data in order to obtain more knowledge of the subject and to be able to answer the research question. Throughout this thesis, we combine theory and the empirical results and thereby we are able to combine the advantages that exist in both the deductive- and the inductive approach. The empirical results from the investigation, combined with previous research and theory also enables the discovery of new patterns which in turn can generate increased knowledge and understanding for the

studied phenomenon. The abductive approach increases the possibility of finding new- or clarifying existing relations. (Alvesson et al., 2000)

Initially we use the deductive approach where we assimilate previous research and theories in order to gain knowledge of why a switch of professional audit firm occurs in the private sector or in the municipal sector in foreign countries. The investigation will be conducted with theory and existing research as a basis. By adopting the inductive approach, we will although be open-minded when the investigation is conducted and therefore be responsive to other factors than those represented in the theoretical framework may occur. (Alvesson et al., 2009)

### **2.3 Choice of theory**

Previous research and theory will give us the background we need to continue this study. These studies show why a switch of audit firm in the private sector and in the municipal sector in foreign countries occurs (see for example Carrington et al., 2007; Deis et al., 1992; Simunic, 1980). Theories that we believe can explain why municipalities switches professional audit firm is: agency theory, signalling theory and legitimacy theory. In addition to these theories, previous research is applied.

The signalling theory is applied to explain how signalling certain behaviour might give the municipality and the politician's support for their actions towards the citizens. This theory will also be used to explain how politicians can present information to gain credibility (Carpenter et al., 2001). Legitimate behaviour is something that may be signalled to enhance the politicians' position towards voters or to make the municipality look successful. Therefore the legitimacy theory will be used to understand how and why legitimate behaviour is an affecting factor of why a certain professional audit firm is procured (Tilling, 2004).

The agency theory is used to explain the relationship between the principals and the agents which is often based on self-interest (Zimmerman, 1977). Previous research that is used in this thesis explains why municipalities shall regard factors as commitment, independence, political competition audit fee and audit quality of a procured audit service. The commitment stands as a solid base when a business-to-business

relationship evolves (Moormen et al., 1992). The closeness that commitment causes might result in lack of independence which can affect the audit quality (Raiborn et al., 2006). The audit fee is also a factor that can affect the quality of the procured audit (Gregory et al., 1996).

### **3 Municipal audit and the procurement process**

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*This chapter will give the reader an explanation of the municipal audit, followed by the procurement process of professional auditors. We find this properly since this process is the essence of what we intend to investigate. This chapter will also present the different professions that will be interviewed and who are in some extent involved in the switch of professional audit firm.*

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#### **3.1 Why audit**

The audit processes within a municipality have a strictly democratic control function. The purpose is to monitor the municipality and try out its responsibilities towards the citizens. The fundamental meaning with the audit is to evolve the democracy and assess the principle of legal security. (SKL, 2006)

In every organisation there is an agency problem, the agents (politicians) shall act in the interest of the principals (citizens), a problem arises when the agents act in self-interest (Hatch, 2002; Zimmerman, 1977). The major reason to hire an auditor is to help control the conflict (Chow, 1982). The politicians govern the municipalities and they have indirect access to the tax funds, the welfare of the voters is therefore dependent on the actions of the politicians. The politicians influence the citizens since it is the politicians who decide which services that will be provided, services that are mainly financed through tax money. To get re-elected or advance in their careers, the politicians although have to consider the voters and the politicians will therefore try to maximize their own utility. (SKL, 2006; Barber, 1983; Zimmerman, 1977) This can be achieved through the distribution of resources, such as tax money, which is affected by the accounting choice made by the politicians. (Falkman et al., 2008; Zimmerman, 1977) Therefore, it may be important for the citizens to monitor the politicians (Baber, 1983).

### **3.1.1 Management- and financial audit**

The municipal audit is, as mentioned above, a democratic control instrument. Since the municipal council assigns the municipal audit board, the municipal audit board is influenced by the municipal council attitude towards the audit in itself. The municipal audit in Sweden consists of two branches, financial audit and management audit. Management audit has got the main focus when the audit board performs their review in the municipality. The audit should therefore have a focus on the processes in the municipality. The municipal audit board has a responsibility to ensure that the separate boards have a well functioned internal control system and when the boards are audited it is the control system that is reviewed. There is also a mission to review the trustee politicians that the municipal organizations consist of. In this review the municipal audit board shall have the citizen's perspective in mind when the audit is conducted. The audit has a unique role when they provide a ground for the municipal council's decision to give freedom of liability. The municipal audit board cannot by them self give a board or a single politician freedom of liability. (SOU 2004:107a) The evaluations of the trustee politicians in the municipality are an open act which is public information and are decision basis, presented to the municipal council who then will decide in granting freedom of liability (SOU 2004:107b).

The focus on management audit is not common for all countries to contract out, it is an European and mostly a Scandinavian behavior which differ in extent between countries. The management audit is one part that the professional auditors have difficulty to fulfill when the municipality is contracting out audit services. (Johsen et al., 2004) The professional audit firms are mainly focused on the private sector where the financial audit is in focus. The financial audit in the municipal sector is to ensure the financial status and to withhold that the accounting is produced according to legal demands. To ensure that the municipality is using their tax funds in the most efficient- and the most beneficial way, management audit is the important tool which requires a great knowledge of municipal activities. By contracting out audit services to a professional audit firm that possesses both the financial knowledge and the management knowledge of a municipality is the most beneficial way to gain economic of scale. (Johnsen et al., 2004b) Since the municipality is monitored by its principals, the economy of scale supports the usage of tax funds in a resource effective way and citizens will receive more value for their money (SOU 2004:107b).

### **3.2 The election of auditors**

Every fourth year the representative assembly is elected in each municipality. When this occurs, the new elected council shall select at least five trustee auditors. The employer of the trustee auditors is the municipal council, which uses the trustee auditors to review the activities of the boards and if they use available resources in an efficiently way. (Bohlin, 2007; Lundin, 1999; Municipal Act) As mentioned in the first chapter, the functions within a municipality are to 70 percent financed through tax money (SKL, 2010b). It is therefore important that the citizen trust the politicians in the municipality (Lundgren, 2008; Cassel, 2000). To gain trust by society, it is important that the trustee auditors take an independent position relative those who will be reviewed. Their work must also be characterized by objectivity and impartiality and therefore, the trustee auditor cannot have any other assignments of trust within the municipality. (Bohlin, 2007)

There are no requirements of what qualifications trustee auditors must possess, it is though essential that they have political experience and a good knowledge of the activities within the municipality (Bohlin, 2007). According to the Municipal Act, the trustee auditors shall be assisted by professional auditors, which are elected by the trustee auditors. These auditors shall be hired in the extent needed and they shall have the insight and experience of municipal audit that is needed to fulfil the assignments (Bohlin, 2007).

The result of the review shall, as in private companies, be reported in the audit report, which is handed to the municipal council. Complaints towards the activities will be presented in the audit report and it will also contain recommendations whether the auditors grant or reject freedom of liability. To make the report as complete as possible, the professional auditor's report shall also be attached. (Bohlin, 2007)

#### **3.2.1 The procurement process**

The professional auditors derive from professional audit firms who are contracted through a procurement process, which stipulates the specific qualifications for the professional auditors. It is the trustee auditors that are responsible for the procurement and this process cannot be outsourced to another unit within the municipality. The

procedure is complex and support from different departments of the municipality is used sometimes. It is also important to emphasize the significance of the trustee auditors' influence over how the terms of reference, contract documents and specification requirements will be formulated. (SKL, 2010c; Svenska Kommunförbundet et al., 2001)

The responsibility of hiring professional auditors rests with the trustee auditors and the only direction from the Municipal Act is, as mentioned in previous section, that the professional auditors must possess knowledge and have experience in municipal operations. The Law of Governmental Procurement states that municipalities shall choose between the firm with lowest audit fee or the economical most favourable firm. Further competence requirements are not specified but according to generally accepted auditing standards it is stated that the professional auditors shall have theoretical– and practical competence in a variety of areas. (SKL, 2010c; Svenska Kommunförbundet et al., 2001)

The success of a procurement starts with a thorough initial work over what requirements and qualification that the tenders need to hold. The specifications shall describe the mission, specify how- and what content that must be presented and describe the criterions the tenders will be judged after. Once the municipality has received the tenders they are compiled in order to make a decision. The different firms that compete to supply the professional audit services are first reviewed by a qualification test to assess whether the firm has the capacity and general ability to perform the mission. This basic requirement consists of that the firms must have submitted the information that is requested. Further on, the firm must have fulfilled its obligations to society in terms of registration, taxes and fees. They must also prove that they have the qualifications that are demanded, such as skills and experience of the particular service. When this is clarified it is common that the different firms with their professional auditors present themselves for the trustee auditors so they can form an opinion and interview the persons concerned. (SKL, 2010c; Svenska Kommunförbundet et al., 2001)

The next step of the procurement process consists of a suitability test of the firms for the particular mission. This can be done by two different methods, either to find the firm that offers the service to lowest audit fee or the one with the most economic advantages.

The procurement of an audit firm often examines which firm have more economic advantages to offer where both audit fee and quality are taken into account. The trustee auditors that are responsible for the process have also defined clear criteria that must be fulfilled by the professional auditors. These criteria should, if possible, be ranked and weighted to ease the decision-making. The trustee auditors make an individual evaluation of the different firms and their ability to meet the criteria, which later are summarized to a collective result, which is the base of the decision. (SKL, 2010c, Svenska Kommunförbundet et al., 2001)

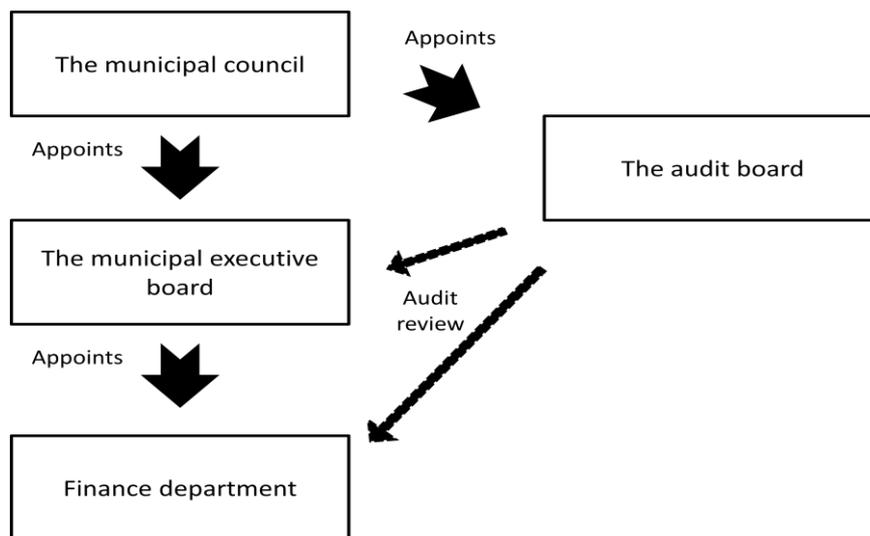
### **3.3 The connection between the professions**

#### **3.3.1 Municipal council**

The municipal council is, as mentioned before, the employer of the trustee auditors and the highest decision making body within the municipal organisation. Since the municipal council is the employer, there is a legitimate interest in controlling the audit process. The Municipal Act provides the municipal council with opportunities to influence the trustee auditors, foremost through controlling the audit process in a discreet manner. The opportunities to influence are although restricted because they must follow the general accepted accounting standards. The Municipal Act also regulates high demands of independence and integrity of the audit process. The result of the review will although be dependent on the intentions of the municipal council since the audit might be customized after the desires of the municipal council. (Lundin, 1999) The chairman of the municipal council is an appointed politician from the majority party. The role of the chairman is to control the council and to govern the municipality in its duties towards the citizens. (Bohlin, 2007)

### 3.3.2 The municipal audit board

The municipal audit board consists of politicians who are elected by the municipal council to be trustee auditors that will review the municipality. The municipal council stipulates the assignments that the trustee auditors shall conduct and the number of trustee auditors depends on the size of the municipality. The municipal audit board reports directly to the municipal council by conducting audit reports, which are presented in the municipal executive council. It is up to the municipal council to decide if there is a need to adjust or change the municipal audit board. The assignments of the chairman of the municipal audit board are to monitor that the municipal audit board follows the guidelines and that the review processes is working in an efficient way. The chairman's duty is also to control that the procurement of the professional audit firm is conducted in a proper way. (Häggroth et al., 2002)



**Figure 1:** The figure shows how the different professions are appointed and how the different professions are connected.

### 3.3.3 Municipal executive board

The municipal executive board is a central administrative body in the municipality and appointed by the municipal council (Bohlin, 2007). The body's main objective is to lead and coordinate the municipal stewardship. The municipal executive board shall also deal with objectives that concerns the municipalities overall development and financial status. They shall execute the decisions taken in the council and present the results of the action to the municipal council or the concerned boards. (Municipal Act) The duties

of the chairman are to control and assist the municipal executive board in its decision-making.

### **3.3.4 Finance department**

The CFO in a municipality is an employed officer, and not an elected politician, that works with the economical operation. The task for the CFO is to lead the finance department, which is similar to a finance department in a private company. The guidelines for the department are stipulated from the municipal council. The assignments that are performed by the department are to produce budgets and to control the financial situation within the municipality. The duties of the CFO are to make the municipality's financial organisation correspond to the overall objectives given by the municipal council. This involves everything from keeping everyday accounting records to make the financial control work efficiently. (Solli, 2000)

## **4 Theoretical Framework**

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*In this chapter, chosen theories are presented. These are assembled to provide a framework that will be used to discuss the empirical results and be able to answer the research question of this thesis.*

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### **4.1 Theoretical basis**

The chosen theories and previous research are united under two different perspectives: the buyer- and the seller perspective. Our focus is the buyer perspective, the seller perspective is although relevant since they have an impact on the services they offer and if the buyer is not satisfied, a switch will take place (Raiborn et al., 2006). A number of the chosen theories and previous research are conducted in the private sector or in the municipal sector in foreign countries, we have used these to draw parallels to the municipal sector in Sweden. We believe this can be done because the role of the auditor in the different sectors are basically the same, namely to review and ensure procedures. The difference is although that financial audit is the main focus in the private sector and in the municipal sector in foreign countries while managerial audit is the main focus in the municipal sector in Sweden (Johnsen et al., 2004). The professional auditors are also not as independent as auditors in the private sector. In the municipal sector, professional auditors do only act independent Cassel (2000).

In all service markets there is a buyer- and a seller perspective. The municipal sector is not an exception; the municipality buys services from the professional audit firms. The relationship between these parts depends on different forces, which drives the parts to interact with each other and the relationship is more of a strategic tool to achieve the goals of both parts. (Wilson, 1995) There is both a monetary- and a non-monetary relationship since not only audit fees and engagements costs matters, public trust and legal liability is also important. As in all relationships, both the municipality and the professional audit firm shall act in a way that enhances the relationship. (Raiborn et al., 2006)

## **4.2 Signalling**

The audit committee in a municipality is using a professional audit firm as an advisor to gain credibility and thereby legitimacy which can be signalled to the stakeholders (Carpenter et al., 2001).

The signal theory was first developed for an explanation purpose to understand how the information asymmetry affects the labour market. The theory has been adjusted to explain why corporations do or do not disclose information about its business. (Campbell et al., 2001; Verrecchia, 1983) To draw parallels to the municipal audit sector, Carpenter et al., (2001) claims that the politicians will signal what they think will give them credibility among the stakeholders.

Politicians are constantly exposed to competition from other parties and according to Baber (1983) they are always looking for ways to present them self in the best possible manner. By contracting well-established professional audit firms will therefore signal high audit quality and honesty (Bettie et al., 1998). The professional auditor will convince both internal- and external stakeholders that the interpretation made by the accountants in the municipality, presents a reliable image of the operations (Soltani, 2007). By disclosing the usage of professional audit firm in the financial statement, this can be noticed by the citizens in the municipality who hopefully will feel trust towards the politicians and feel that their work is done properly. (Campbell et al., 2001).

When documentation and performance measures are available one assumes that these will be used. The study by Hanberger et al., (2005) although show that audit reports are rarely used by the citizens. This might be a result of that the audit reports are foremost compiled for the elected representatives. The reports can be used by the citizens to form an opinion about accountability before they vote. The reports are although often hard to put into context, they are not written in a language that ordinary people understand and few citizens are informed that such reports exists and therefore the reports have limited value for citizens own democratic control. When this is the case, media can work as a good signaling tool towards citizens since journalists with a financial background can easier understand financial reports. (Hanberger et al., 2005)

Hanberger et al., (2005) concludes in their study that the most important reviewers in a municipality are the trustee auditors and media and therefore the trustee auditors and media have relatively large importance when it comes to local politics and administration. When it comes to media, it is foremost local newspapers that are of importance and no other reviewer can affect the image which is given to the citizens within the municipality in such a way that media can. (Hanberger et al., 2005)

#### **4.2.1 Legitimacy**

The work of politicians is affected by the need of society to trust them, in order to get accepted and thereby become re-elected (Zimmerman, 1977). The need of legitimacy is therefore a great part of the politician's everyday work. Coicaud et al., (2002) divides the legitimacy of the political work into two conditions. First, a municipal work is legitimate if there is a mutual exchange between the politicians and the citizens. Second, legitimacy can appear if the politicians express values that are generally accepted by the community. The first condition point to the self-interest of all people and the need to satisfy every individualist needs, both politicians and citizens. The second condition is pointing towards how to communicate these values and actions in a proper way to the society. (Coicaud et al., 2002)

The legitimacy theory is a common used theory when explaining the purpose of disclosures (Tilling, 2004). Legitimacy in itself is defined as generally accepted actions or behaviours that are in line with common norms, values and definitions. To gain a full legitimate behaviour the organisation either builds firstly all its internal and then external operations according to general accepted actions or create a new behaviour with the help of a legitimate partner that ensures the actions. (Suchman, 1995) Mathews (1993) explains legitimacy as a continually attempt to establish congruence between social values and the activities that are performed. If this is not accomplished, a gap appears between the activity and the social value and a threat to the organizational legitimacy will appear. Just like money, legitimacy is a resource that is required to operate. When an organization is facing low legitimacy one consequence can be that society loses faith in the organization. (Tilling, 2004)

In municipalities, the actions that politicians perform will face the judgment of the citizens. In order to show that right actions are taken, this can be signalled through the audit process, which can be used to show legitimacy. According to Guénin-Paracini et al., (2010), auditors have an impact on the social environment and can convince society that certain behaviours are legitimate. In order to be legitimate, an organization can either procure services or enter a business contract with partners that are already legitimate to enhance their own legitimacy (Tilling, 2004). The buyer of the audit service will be affected by the legitimate appearance that the provider gives (Guénin-Paracini et al., 2010).

The Big Four have more channels to be legitimate and they have a larger organization in order to communicate a good behaviour than smaller audit firms. The Big Four are also assumed to offer and signal a higher quality of their audit than smaller audit firms. (Chang et al., 2008) Coicaud et al., (2002) explains that the politicians have a need to reflect a good behaviour and by contracting audit firms with high reputation, the politicians will gain legitimacy.

### **4.3 Mutual commitment**

There are some main attributes in a business-to-business relationship that will give the buyer incentives to commit to a seller. Commitment is by Moormen et al., (1992) defined as a desire to maintain lasting relationships that creates value. A strong commitment in a business relationship will create an unwillingness to choose other business partners than the current one (Moormen et al., 1992).

Wilson et al., (1995) points to the importance of commitment when studying the buyer- and seller perspective, which is the foundation in business-to-business relationship. Commitment in a business relationship only takes part if the partners have something to gain. Business partners with a strong commitment will not act according to logic behaviours; the relationship will promote positive mental events and create pro-relationship motives. Close personal commitment is a factor that will affect the buyer to overview mistakes and failures. (Finkel et al., 2002)

The study made by Jones et al., (2009) describes what is valued in a business relationship. Personal contact with few persons is more relationship building than having several different contacts in the company. Service providers will gain business if they establish a personal connection to the buyer rather than a formal organisational contact. Trust is also important when building a business relationship. (Jones et al., 2009; Carrington et al., 2007)

Since the fierce competition in the audit sector, the professional audit firms must consider the needs of the client very carefully. The technical qualification is not enough, the firms must be able to provide customer services to satisfy their client. It is therefore important that the firm interact with the client or the presumptive client not least in a proposal mode to understand the clients need in order to be chosen for the assignment. (Addams et al., 2002)

Even though much of the previous research is performed in the private sector, parallels can be drawn to the municipal audit sector where the professional audit firm is concentrated on the commitment phase to be able to either retain existing customers or to sell their services to new customers and enter new business relationships.

#### **4.3.1 Political competition**

As mentioned in the third chapter, there is an agency problem in every organization (Hatch, 2002; Zimmerman, 1977) and politics is no exception (Becker et al., 2009). The voters are concerned with the election of competent politicians but they cannot observe the ability and effort performed by politicians, such as time devoted to their work. The most important tool to keep elected politicians accountable for their actions is electoral competition. Through the election, the voters can punish the elected politicians for neglecting their responsibilities as a politician and vote them out of business. (Becker et al., 2009; Hanberger, 2006)

Political competition will increase the welfare of the voters (Wittman et al., 1996; Barro, 1973; Stiegler, 1972) since competition among political parties maximizes the welfare of the voters and since it reduces political rents, such as tax price at which services are supplied. Blank et al., (2009) concludes that audit fees rise with rising

political competition. Both the administrators and the contestant political parties have incentives to make sure that relevant information is being produced (Blank et al., 2009). This is because political competition works as an information-revealing mechanism which will improve the efficiency of the principal-agent relationship between the voters and their elected politicians (Padovano et al., 2009).

#### **4.3.1.1 Change in leadership**

In the municipal sector, the citizens divide the seats in the municipal council by an election every fourth year (Blank et al., 2009). The council elects the trustee auditor who in turn chooses the professional auditors. (Cassel, 2000) Previous research in the private sector has shown that a switch in the majority of the management might lead to a switch of audit firm. This research concludes that when the manager director has been switched, there has also been a switch in audit firm. This action is based on the lack of relationship between the new management and the old audit firm. (Hudaib et al., 2005)

Chow et al., (1982) concludes that managers select an audit firm that is able to signal a wanted behaviour and if the old audit firm is able to signal certain behaviour this firm might not be switched to another. Baber (1983) concludes that the incentives for politicians to show accurate behaviour to the citizens are rather high. The complexity in the political market though makes it difficult to determine what incentives politician's have for their choice when switching professional auditor. The switch is although in some part affected by the political competition. (Baber, 1983)

Change in leadership within a municipality comes from the citizens voting results. There is not much knowledge about if citizens believe that voting is an act of accountability or a democratic control function (Hanberger, 2006). Elinder (2010) concludes in his study about voting behaviour in Swedish municipalities that changes in unemployment and change in growth are the most important voting issues. According to Padovano et al., (2009), the citizens often base their voting decision on several issues, such as the performance of the economy during the length of office. Sometimes the voters although consider non-economical issues, such as religion, nation and other similar issues. (Padovano et al., 2009) The influences on the municipal audit are according to Cassel (2000) both financial- and managerial audit that is based on the

operational decisions, therefore the municipal audit can be influenced by what the winning party focuses on.

#### **4.3.2 Auditor independence**

After several audit failures like Enron and WorldCom, auditor independence has become more important for the credibility of the financial statements (Raiborn et al., 2006; Ruiz-Barbadillo et al., 2006). By hiring an auditor to review the financial statements in a corporation, credibility is added, which can reduce the information risk for the stakeholders (Lu et al., 2009). To secure audit independence in the private sector, partner rotation is mandatory in contrast to audit firm rotation, which is not mandatory. Several studies although conduct that an unlimited period of association between an audit firm and their client represent a threat to independence. (Raiborn et al., 2006; Sinnet, 2004)

According to Watts et al., (1986), audit firms that predict that the relationship with the client will carry on into the future may be less observant and do more easily go along with questionable accounting methods. They do this to protect their stream of profit that comes from the client (Watts et al., 1986). The auditor examines the financial statements to assess fair presentation, based on accounting rules and standards. The fewer adjustments that are needed from the auditor, the more quickly the audit are performed and the process will be less expensive. This will satisfy the client and it is more likely that the audit firm will retain the client. In other words, there are strong incentives for the auditor to act the way the client wants, even if it means that dubious accounts are approved and independence is jeopardized. (Raiborn et al., 2006)

Most studies about auditor independence are performed in the private sector or in municipalities in foreign countries which shows that a mandatory audit firm rotation will lead to a limited stream of profit and thereby the economic incentives to act in a non-independent manner will decrease. It will also probably lead to the auditors daring to disagree with questionable client practices since the client will only belong to the audit firm for a limited period. (Kaplan et al., 2008; Raiborn et al., 2006) Several authors although claim that the audit process will be more effective the longer an audit firm has been auditing the municipality. This might lead to a lower audit cost for the

municipality since the audit firm can transfer cost savings to the municipality. (Antle et al., 2006; Craswell et al., 1999; Simunic, 1980)

Opponents of a mandatory audit firm rotation claim that a new audit firm will not have the same client-specific knowledge and this will prevent the effectiveness of the audit process and be a loss to society because the audit process will be more expensive. Proponents on the other hand believe that knowing that another audit firm will review the client in the future puts pressure on the current audit firm to distance from potential client manipulations. A new audit firm will bring a fresh look into the audit assignment and this is an effective way to ensure auditor independence. (Lu et al., 2009; Raiborn et al., 2006; Gómez-Aguilar et al., 2003) Therefore, audit firm rotation may contribute to higher independence among the auditors and thereby, higher credibility of the financial statements is signalled to stakeholders (Lu et al., 2009; Raiborn et al., 2006; Sinnet, 2004).

#### ***4.3.2.1 Independence within the municipal audit***

In the municipal sector in Sweden, the danger of independence is inherent in the political system by the tradition that the trustee auditors are selected among politicians. This is as if the auditors of a private company were appointed and selected among the board members. (Blank et al., 2009)

Since legislation about municipal audit has been strengthened in Sweden, this has introduced the requirement that the trustee auditors shall hire professional auditors when needed. The idea is that independence and competence shall increase. Since the trustee auditors and the professional auditors work in close coordination with each other, it is doubtful whether independence has been strengthened significantly. The trustee auditors are also dependent upon the professional auditors when legislation shall be interpreted and when the focus of the audit shall be selected, which also contributes to the uncertainty whether independence has been strengthened through the legislation. (Hanberger et al., 2005)

The independence within the audit can be viewed at different levels, both in appearance and in fact. When having an audit that is independent and all procedures around it are

separated from interference from the management influence, this is by definition to have independence in fact. This state is often required to gain independence in appearance. To be independent in appearance is to have all activities in an audit to look unaffected by people who have incentives to interfere and control the audit process. A definition of independence is not only to find faults in the audit process, but also to report the faults that have appeared. (Pott et al., 2009)

When the audit service in a municipality is contracted out to a professional audit firm, a problem to keep independence appears since the audit process is restricted by guidelines from the contractor. This makes the contracted auditor not appear independent and can therefore not be seen as an external auditor. In municipalities, the view of a contracted professional auditor is that he/she is an expert in the profession but the actions are limited and the judgement is not the essential factor when decisions of freedom of liability are taken. (Pott et al., 2009; Cassel, 2000) There are recommendations from SKYREV (2010) that stipulate how a professional auditor shall do to gain an independent position when having a municipality as a client. These recommendations, together with municipal laws, makes the audit process appear independent but if it is actually independent Cassel (2000) and Pott et al. (2009) questions. According to Sutton (1997), the municipal audit is only independent in appearance and not independent in fact.

SKYREV who is a certifying organisation for professional auditors and acting in the municipal sector, points to the need of high independence between the trustee auditor and the professional auditor. Therefore a rotation of professional audit firms might lead to higher credibility of the politicians and the citizens will feel that their tax money is used in a proper way. The citizens can easier assume that politicians are doing what they can to maintain independence among the professional auditors which will, according to Raiborn et al., (2006), lead to the auditors daring to disagree with questionable practice. In other words, trust and credibility is signalled through audit firm rotation. This is in benefit for the politicians since the more satisfied the citizens are with them, the more likely that they get re-elected (Zimmerman, 1977).

#### **4.4 Audit fees and audit quality**

Customers are best served when there are many competitive alternatives to choose among on the market. As the competition increases on the supply side this can result in customer benefits, such as lower price of a service or that the offered service will become more cost effective. (Baker, 2004) The opposite of a competitive market is monopolistic or oligopolistic markets which characterize the audit industry where the audit service is provided by relatively few audit firms (Jochen et al., 2008; Bandyopadhyay et al., 2001; Simunic 1980).

Most oligopolistic theories predict that the price of a service will increase when the concentration of market suppliers' increase (Bandyopadhyay et al., 2001). Palmrose (1986) and Simunic (1980) although found the opposite relationship, the Big Four as a group charge lower fees than smaller audit firms and this despite the fact that they are considered to offer higher quality on their audits and have a better reputation than smaller audit firms. Simunic (1980) believe that this finding reflects a sharing of benefits between the audit firm and their clients, which are realized from economies of scale. (Simunic, 1980)

The most important factor when competing with a service seems to be the price (Jobber, 2001; Beattie et al., 1998). DeAngelo (1981) presents that audit fees can be offered at a lower price level in the beginning of a business relationship but the intention in the lengthening is to raise the fees. Several studies discuss this occurrence and are referred to as "low balling". Johnsen (2001) have several explanations to why "low balling" may occur on the audit market. It might be used by the audit firms to niche themselves in a new market where they see potential to invest in specific industry knowledge. A second explanation to why "low balling" may occur is that an audit firm wants to expand into a new geographical area or prevent competitors to take part in a particular market by defending a current client base. This is best achieved through offering the clients a lower fee than competitors. (Johnsen, 2001) There are although concerns that these kind of audit fee reduction is on the expense of audit quality in terms that a cut in the audit fees are achieved by reducing the number of hours spent on the review of the professional audit firm. (Gregory et al., 1996)

In the Swedish municipal sector, Molander (2009) concludes that there are no empirical evidence that low price on the procured service will be equal to low quality of the procured service. Molander (2009) concludes that in the Swedish municipal sector an evaluation of the offers is thoroughly conducted so that the procured services meet the required standards. The price of the procured service shall not be used as an indicator of how the quality of the procured services is perceived. (Molander, 2009)

#### **4.4.1 Specialists and audit quality**

When municipalities switches professional audit firm, this might be a result of the municipality seeking professional auditors who is more specialized in their field. The switch may also be a result of the municipality becoming more complex and therefore greater specialization is needed (Nasser et al., 2006). As mentioned in the first chapter, there is one firm that is specifically concentrated on audit in the municipal sector in Sweden, Komrev, who is the largest actor and former owned by Kommunförbundet (Cassel, 2000).

To be the largest actor in a sector may lead to supply-side signalling benefits, such as good quality. A company that is considered to offer high quality products- or services can charge higher fees, which in turn will be a signal of good quality. (Ferguson et al., 2006; Ellingsen, 1997) The largest audit firm in a specific industry might although easier lead to cost benefits which can be transmitted to the clients and therefore reduce the audit fees. Further on, by being the market leader might although signal good audit quality and specialist knowledge and therefore municipalities might be willing to pay more for the audit service from this firm (Deis et al., 1992; Ettredge et al., 1990)

When a switch of service provider occurs, a risk may emerge. It can evolve because the buyer will not know if the quality that will be delivered is satisfying. This can lead to a rise of monitoring costs for the buyer. This cost will although decrease when the buyer starts to feel confident about the seller. (Porter, 2004)

Quality is a complex variable to measure. One way to measure quality is to count the number of hours that the professional audit firm has audited. (Deis et al., 1992) A measure of quality can also be the extent of industry specialist used in an audit process.

The specialist has better knowledge and can therefore solve an assignment more cost effective. Therefore a specialist may be a better choice when achieving higher audit quality and this may be the purpose for the switch of professional audit firm. (Green, 2008) Deis et al., (1992) and DeAngelo (1981) defines audit quality as the probability that the auditor will discover and report faults in the client's accounting system. When considering municipalities, the definition must include a judgement whether the activities are run in a way that is adapted to its purpose and if it produces value for money (Blank et al., 2009).

It is often more difficult to evaluate a service than a product. The technical features of a product are easier to compare than the more soft values as a service provider. Whether a service is performed within the private or the public sector do hardly have any directly differences. The difference could though differ regarding in what environment the service is performed. The services and the quality of services within a municipality are political decisions and the objectives for the services are in compliance with the national economical objectives and there are many different definitions associated with service quality. Quality is often based on the customer experience of service. The functional quality of service, how the service is performed, plays a large role in determining the overall impression. (Grönroos, 1994)

## **5 Empirical Methodology**

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*This chapter will describe the procedure in the empirical investigation. First we present why the qualitative method is appropriate in this study which is followed by the description of a case study. A description about the data collection method will be given where we explain the survey, the selection of municipalities- and respondents. Further on, we present semi-structured interviews and the interview guide. This is followed by data handling and criticism of the sources.*

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### **5.1 Qualitative method**

The aim of this master thesis is to create a better understanding for what factors and why these factors affect a switch of professional audit firm in the municipal sector in Sweden. We intend to investigate a complex area where interest lies in extracting the respondents' opinions in our empirical area and to be able to understand the respondents' experiences and reflections. Therefore we must use a method that enables this and not, as in a quantitative investigation, by generalize a large number of units. (Bryman et al., 2005; Jacobsen, 2002) Our aim must be investigated through analysing people's opinions and behaviour regarding the switch. The qualitative method is favoured since it more easily can capture individuals' point of views and it will give us the opportunity to obtain a richer understanding for the phenomenon. Therefore a qualitative method is chosen. (Bryman et al., 2005; Flick 2005; Denzin et al. 2000)

### **5.2 Case Study**

The research question in this thesis is "*why do municipalities switch professional audit firm*". According to Yin (2009), a "why" question is likely to be best solved through a case study since such questions deal with operational links which have to be traced over time, rather than mere incidences or frequencies. A case study is also appropriate to conduct when the researcher wishes to investigate a specific occurrence since it is the case that is of interest and the goal with the study is to illustrate unique features in the

specific case. (Bryman et al., 2005; Jacobsen, 2002; Silverman, 2010) This study will be conducted by multiple case studies to see if there are common factors in the selected municipalities that pervade the choice of switching professional audit firm in the Region of Skåne. Studying several municipalities gives a more comprehensive description of the phenomenon than studying only one municipality. (Jacobsen, 2002; Yin, 2009)

A strength with case studies is that the case can be understood in its context and if several cases are investigated the researcher can experiment with the single case as well as compare them against each other to find tendencies in the specific occurrence (Yin, 2003). A disadvantage with a case study is the difficulty to generalize the empirical results in statistical sense since only a small amount of units are investigated (Jacobsen, 2002; Yin, 2003). The objective of this study is, as mentioned in section 5.1, although not to generalize our empirical results statistically.

### **5.3 Data collection method**

Since the study applies a qualitative method, there are several data collection methods to use, such as observations, interviews and documentary study etc. The use of one method does not exclude another and when using a qualitative method, a combination of several methods is often used. (Bryman et al., 2005) In this study however, a document study followed by a survey and interviews are performed.

#### **5.3.1 Primary- and secondary data**

The primary data is collected by us personally through interviews. (Saunders et al., 2009) The interviews are conducted with respondents in selected municipalities which we present below. The secondary data that is used in this study are financial statements and procurement documents from the latest procurement of a new professional audit firm. Since this data derives from the municipalities themselves, the data is likely to be reliable and trustworthy (Saunders et al., 2009). The financial statements are used in the first phase to find out which professional audit firms that are used among the municipalities in the Region of Skåne. The procurement documents are used as a support when the interview questions are formulated. The documents are later used to compare the answers from the respondents about what the procurement document say about the weighting of different variables, such as audit fee and quality.

### **5.3.2 Selection of municipalities**

There are 290 primary municipalities in Sweden and since there is a time limitation for this thesis the ability to conduct a comprehensive study of all primary municipalities is delimited. Therefore, we have chosen to study selected municipalities in the Region of Skåne. This region is also selected since the intention is to perform personal interviews and this is easier to perform when you have the respondents in a short distance.

#### **5.3.2.1 The document study and the survey**

As a first step to find which municipalities to study, we performed a document study which is followed by a survey. First we looked through all financial statements of the municipalities in the Region of Skåne over a certain time period. This was performed to see if it was possible to get information regarding which professional audit firms that were used during this time period and which municipalities that had switched professional audit firm during the last procurement process. The chosen years are 2004 and 2008 since they represent a point in the middle of two election periods and can therefore be seen as relatively neutral to electoral political influences. The information that was found was not complete and therefore we performed a survey where we made a cyclical call to all municipalities in the Region of Skåne and got hold of the information needed. We were confirmed that several municipalities had changed professional audit firm the last period of procurement.

#### **5.3.2.2 The selection**

Yin (2009) argues that with a study with two cases, the possibility of direct replication increases. In this study, 3 of 33 primary municipalities were selected. The selection was made in consideration of changed- and unchanged governance, size of the municipality measured in numbers of inhabitants in comparison to the average municipality in the region of Skåne that procure professional audit services from a single firm and to what extent the municipalities have switched from different professional audit firms. Changed- and unchanged governance was chosen in order to consider if political influences may affect the switch. Size was chosen since a comparison can easier be made when the municipalities are equal in size. We also believe that a deformity may

arise when you compare very small municipalities with very large municipalities. The third criterion, to what extent the municipalities have switched from different professional audit firms were chosen in order to avoid firm specific behaviours that might have an impact on the switch.

### **5.3.3 Selection of respondents**

There are several criteria to be aware of when selecting respondents in an investigation (Jacobsen, 2002). Our selection is governed by the intention of the study and the type of information sought. By carefully examine and defining the qualifications needed from the respondents, we have been able to find appropriate respondents for this study. The representatives in the municipalities that we have chosen to interview are therefore, in different extent, all involved or affected by the audit and might therefore have an insight into the procurement process which is the basis for the switch of professional audit firm. We believe this insight can contribute a better understanding to why a switch of professional audit firm occurs and thereby find the affecting factors.

We have chosen to interview twelve persons in four different positions from the municipalities. This because we believe that there is differences in what persons with different positions experience when the municipality decides to switch professional audit firm. This will also give us different opinions regarding the switch which we believe will give us a richer understanding of the phenomenon than if only persons with one position or if only persons that are direct involved in the process were interviewed.

The respondents in the municipalities possess the following positions; chairman of the municipal council, chairman of the municipal executive board, the chairman of the audit board and the chief financial director (CFO). The chairman of the municipal council was selected since the municipal council is the highest decision making body within a municipality, the employer of the trustee auditors and this council stipulates the assignment that the trustee auditors shall conduct. Since it is the chairman of the municipal council shall control the council we believe that he/she might therefore be the person that can affect the trustee auditors and thereby the audit and the procurement document the most. The chairman of the municipal executive board was selected since he/she is one of the persons that shall be reviewed. Our thought is that persons in this

position has probably some standpoints about the review and how the professional auditors do their job and he/she can give us a view of the switch of professional audit firm from another perspective since he/she is not directly involved in the procurement process.

The chairman of the municipal audit board was selected because he/she is the one that shall control the procurement process and make sure that the review process of the different boards are working in an efficient way and might thereby have the greatest insight in the procurement process. The CFO was selected even though municipal audit is mainly about managerial audit and not about financial audit. As we conducted the first survey where we did a cyclical call to all municipalities in the Region of Skåne (see section 5.3.2.1) we talked to several CFO:s. The impression we got was that the CFO:s are often involved in the procurement process and some of them believe they have a fairly large role in the procurement process in spite of that they shall be reviewed in the audit process and therefore they shall not have any opinions. We also found out that many CFOs have worked as authorized auditors in audit firms before they became CFOs. The CFOs in our case study do all have a history as authorized auditors in audit firms. We find this interesting since they might contribute with a wider perspective to our issue.

#### **5.3.4 Semi-structured interviews**

In a qualitative research, interviews are one of the most common methods to collect primary data (Bryman et al., 2005) and Yin (2009) believe that interviews are one of the most important information sources when performing a case study since there is a focus directly on the studied topic within the case. Interviews also give immediate access to experience (Silverman, 2010) and we have the ability to customize the data, which is conformed to the aim of the thesis. (Saunders et al., 2009)

We have chosen to perform qualitative interviews which can consist of unstructured- and semi-structured interviews. Since we seek answers to specific questions, the unstructured interview is not appropriate because this type of interview is more like a conversation without specific questions. (Bryman et al., 2005) The unstructured interview may also result in the collected data is far too complex to analyse (Jacobsen,

2002). Since the aim with the interviews is to achieve a deeper understanding for why municipalities switch professional audit firm, we have therefore decided to perform semi-structured interviews. Semi-structured interviews offer a flexibility that is of importance since it allows the respondents to address their own experienced views that is important which will give us a more detailed knowledge (Troost, 2005).

#### ***5.3.4.1 The procedure of the semi-structured interviews***

The twelve respondents are all interviewed individually which allows us to be flexible in the interview process and ask questions that can vary depending on the flow of the conversation. We can omit questions that are not suitable for some of the respondents and the semi-structured interview method also permits us to ask additional questions to be able to answer the research question. The questions are although never deviated from the aim of this thesis. (Saunders et al., 2009)

The intention has been to conduct personal interviews. The reason is due to several advantages, such as higher quality and the possibility of more complex follow-up questions and answers. (Wiederheim-Paul et al., 1991) It has although not been possible to conduct personal interviews with all respondents because some of them did not have the time for personal meetings and they would rather be interviewed on the telephone. Eight personal- and four telephone interviews are performed in the first interview phase. When the compilation of the answers is conducted, additional telephone interviews are performed with all twelve respondents in order to collect missing information. The advantages with telephone interviews are that the interviewer does not affect the respondents, therefore the interviewer effect is reduced (Bryman et al., 2005). A disadvantage is although that the interviewer loses the opportunity to observe how the respondents behave in certain matters.

The questions asked in the interviews are not sent out to the respondents in advance, this because the respondents shall not be able to angle their answers in beforehand. The respondents although got a review of the purpose of the thesis in order to be prepared in the subject. (Saunders et al., 2009) The personal interviews took place in the respondents' everyday environment in order to minimize the context effects, which may lead to the respondent giving mannered answers (Jacobsen, 2002).

All of the three authors of this thesis have participated in the interviews. Both the personal- and the telephone interviews are recorded and committed on the computer in order to not omit important information and every interview took about one hour. The interviews took place on different days, with the four respondents from one municipality each day. The reason why we waited one day before we interviewed the respondents from next municipality is because we needed time to reflect over the previous performed interviews.

The respondents have only spoken in terms from the municipality in which they operate, hence no generalization of all municipalities have been made. Although, it should be kept in mind, since the respondents share their own views and thoughts of what factors that have an impact on the switch of professional audit firm, the statements may be affected by a subjective interpretation. We although believe that this problem is solved since four people from three municipalities with different views of the procurement process are interviewed.

#### **5.3.4.2 Interview guide**

In order to be as prepared as possible for the interviews, an interview guide is set up. The interviews contain of specific themes, which will be handled during the interviews and the questions are foremost related to chosen theories and previous research. The guide makes the replication of the study possible, which will lead to increased reliability. The themes in the interviews must be well thought out to gain trustworthy answers from the respondents, this will also increase the validity. (Jacobsen, 2002) A certain structure is important since the respondents shall stick to the chosen topic, the respondents must although be able to answer without being controlled by the questions. The themes are not mentioned during the interviews in order to be able to capture all aspects concerning the switch of professional audit firm (Kvale et al., 2009). We are also observant of that the respondents can refer to other factors than those presented in the theoretical framework.

We have chosen to develop a brief- but structured interview guide which makes it possible for us to be flexible with the questions. (Bryman et al., 2005) The guide

consists of four themes which are followed by related questions which represents each theme but also gives the respondents the opportunity to bring in more aspects in their answers. These themes are foremost formulated to keep a focus in the interviews that will help us keep progress in our work. The guide needs to be carefully developed in order to not confuse or lead the respondent in a certain direction (Saunders et al., 2009). The purpose of the guide is also to prevent that none of the themes are missed out. A further advantage with an interview guide is that it is easier to compare the answers of all respondents, which will increase the reliability. (Bryman et al., 2005)

### **5.3.5 Anonymity**

The names of the interviewed municipalities or respondents will not be published in the thesis since we do not find this relevant for the aim of the thesis and it is important that the respondents dare to speak freely and their integrity must therefore be protected. (Bryman et al., 2005) We will although publish which position each respondent have. It is difficult to know whether or not we have received qualitatively better information because of this, we although believe that the respondents have dared to be more open.

## **5.4 Data handling**

As previously presented, all interviews are recorded and committed on the computer in order to not omit important information. After each interview we have carefully listened through each interview several times to first get a rich understanding and later pinpoint the essence of the answers and the stories. Subsequently the most interesting and apprehensive responses is selected. All empirical data is underlying the analysis but only parts of the empirical data will be presented and analysed, this considering the vast amount of empirical data collected and we do not find all data relevant for the subject.

Based on the theoretical framework, we have chosen to create five headings with related subheadings in the empirical- and analysis chapter in order to maintain a structure that is easy for the reader to follow. We have chosen to present empirical data with associated quotation which is related to appropriate theory and previous research which is finally analysed, that is to say, our own interpretation. These interpretations are later the basis for our conclusions.

## **5.5 Criticism of sources**

The scientific articles used in the theoretical framework are selected with the intention of being as trustworthy as possible. We are well aware of that these articles are published for one intention that probably is not fully suitable for this research. Since we are aware of this circumstance, we are more critical to the chosen theories and previous research. Many of the scientific articles are referred to in other research articles and these are therefore seen as more reliable. (Thurén, 1990)

The interviews with the respondents are trustworthy primary sources since they have insight in the municipalities operations and procedures, they are also involved or-/and affected by the audit. The interviews conducted over telephone could cause a problem when comparing them to personal interviews since we are not able to see the reaction of the respondents (Bryman et al., 2005). This affect is taken into account when the interview is conducted. To avoid the subjective view that can be given by one respondent, we have interviewed several persons who are involved or affected by the switch of professional audit firm. The fact that all of the authors do participate in the interviews will decrease the subjective view. (Thurén, 1990)

We have also used electronic sources. When conducting information from these sources, a critical review is needed because the data is not published and therefore less reliable. The electronically sources although derives from SKB and Statistiska Centralbyrån (SCB), which we find as reliable sources. (Thurén, 1990)

## **6 Empirics and analysis**

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*In this chapter the empirical results will be presented and analysed with help from the theoretical framework. We start with a short presentation of the interviewed municipalities and the results from the survey. After this, audit fee and quality are presented since these are factors within the procurement document. Otherwise the chapter follows the same structure as the theoretical framework. For the clearness, we have chosen to systematically first specify the empirical results followed by theory which is subsequently analysed.*

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### **6.1 Information about the municipalities included in this study**

The three municipalities that are included in this study are located in the Region of Skåne and the population ranges from 15,000-19,000 which represents an average municipality in the Region of Skåne. All three municipalities have during the last election switched political majority, one municipality have switched from a right-wing majority to a split governing. The other two have switched from a left-wing to a right-wing majority according to statistics from SCB and the chosen municipalities have used different professional audit firms before the switch.

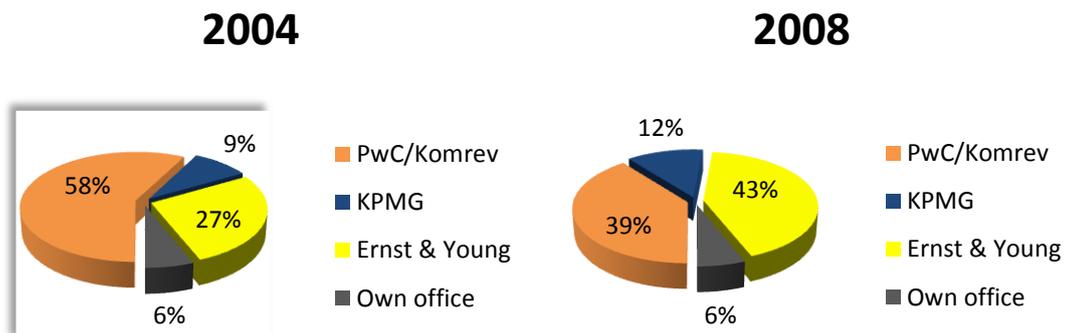
As mentioned in the empirical methodology, we have interviewed the chairman of the municipal council, the chairman of the municipal executive board, the chairman of the audit board and the CFO from three different municipalities.

### **6.2 The survey: market shares of professional audit firms**

The first survey that is conducted, where we made a cyclical call to every municipality in the Region of Skåne, show that the distribution of market shares has changed during the time period from 2004 to 2008. The results from the study show that the professional audit firms used are PwC, Ernst & Young and KPMG. Two municipalities use their own audit departments, these two municipalities although procure services

from professional audit firms when special qualifications are needed. In the survey, the procured services from these two municipalities are not accounted for. Market share is in this study defined as the amount of municipalities that each professional audit firm perform audits for. Based on these findings our research question is interesting to highlight. The number of municipalities in the Region of Skåne is 33 and the response rate of the survey is 100 percent.

The result of the survey shows a clear shift in market shares for the two largest actors. It also gives a clear view of that a switch among the largest professional audit firms in the municipal sector has occurred. The market share of PwC/Komrev has decreased substantially over the time period. The firm that has gained market shares in this time period is Ernst & Young, which is the largest competitor in the municipal audit sector in the Region of Skåne. The market position of KPMG is relatively unchanged in this time period.



**Figure 1:** The distribution of market shares in the municipal audit sector in the Region of Skåne, 2004 and 2008.

The distribution of market shares is presented for the respondents in connection to the interviews and no one of the respondents are noticeable surprised that there has been a change in the municipal audit sector. An explanation for this phenomenon, mentioned by nine of twelve respondents is that PwC/Komrev has lost their competitive advantage of being specialists of municipal audit. The competitive firms can offer the same quality of their services to about the same audit fee and since PwC/Komrev has been in the business for a long time there can be a desire to hire a new firm who can see the operation in a different view. All respondents agree of that it is of benefit for the municipalities to switch professional audit firm on a regular basis since this will lead to

a new approach of the audit review which will contribute to a more effective audit process. As one CFO states:

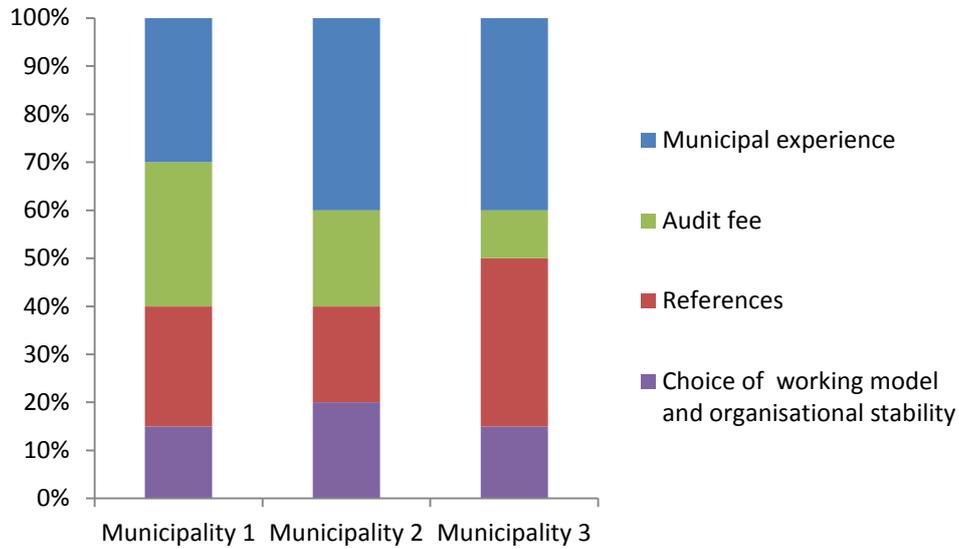
*“New professional auditors will see the audit with fresh eyes and develop the financial reports and the structure of the audit.”*

In the first phase of this study it seems like it is specialization and audit quality that affect the switch of professional audit firm. This is in line with Nasser et al., (2006) who argues that a municipality will switch professional audit firm when greater specialization is needed. Deis et al., (1992) and Ettredge et al., (1990) argue that the market leader will signal good audit quality and specialist knowledge, which might be a reason for the switch. Our interpretation in the first phase of this study is that a municipality will switch professional audit firm since there is a need of greater specialist knowledge and the desire to signal increased audit quality. Nowadays the specialization and audit quality is although equal between the three large professional audit firms. Therefore, and in accordance with Lu et al., (2009), Raiborn et al., (2006) and Gómez-Aguilar et al., (2003), it is of importance to hire a professional audit firm that can help develop the financial reports and the structure of the audit in general.

One CFO argues that former co-workers at PwC/Komrev have been head-hunted by other professional audit firms. He also argues that there is dissatisfaction about that PwC/Komrev is too large and that they cannot handle the promised services. It is also difficult to get in touch with the people concerned and the organization is too large and too bureaucratic. One chairman of the municipal audit board although argues that PwC/Komrev have helped develop the certification for professional auditors in the municipal sector. This license was introduced when the audit was moved from the governmental care to the shape it is in today and this gave PwC/Komrev an advantage over its competitive firms. In later years the other audit firms have gained knowledge about audit in the municipal sector. He also believes that the authorisation have lost its superiority.

In the following sections, we will intimately specify the answers by the respondents about why their municipalities have switched professional audit firm, which contributes to the change in market shares.

### 6.3 Audit fee



**Figure 2:** The diagram summarizes the factors that are looked for according to the procurement documents from the three chosen municipalities regarding the last procurement when they switched professional audit firm.

The different evaluation factors that the procurement is weight upon makes a solid ground for choosing the most suited professional audit firm according to all the respondents. When we ask the three chairmen of the municipal audit boards how the different weightings are set, they refer to a mix of earlier experiences, the objective with the procurement and price of the audit, the audit fee. They explain that the procurement process can be influenced when a special need is to be fulfilled, and therefore the parameters can differ between procurement processes.

Deis et al., (1992) refers to industry specialist as a qualitative criterion. DeAngelo (1981) define auditors capability as the discovering- and report of audit faults, which we interpret as choice of working model and organizational stability. We interpret these two criterions as a quality-criterion.

All respondents agree that the audit fee is the basic factor of the switch of professional audit firm. This even though the audit fee shall only be weighted between 10-30 percent in the three municipalities, according to their procurement documents (see figure 2). All respondents in one particular municipality state that the audit fee is the only factor that is considered to be the decisive in their procurement process. The professional audit

firm with the lowest audit fee tend to always get the contract. The chairman of the municipal audit board in this municipality although believes that there should be additional criteria to consider, such as collaborative and personal chemistry. He refers to their switch of professional audit firm where all trustee auditors received a better feeling for one professional audit firm. They were although not able to select this firm because they did not have any criteria that matched this qualitative criterion in the procurement document. This professional audit firm were marginally more expensive and therefore another professional audit firm were selected. The CFO in this municipality believes that the system of rules regarding procurement is too unclear and complicated. Qualitative criteria are also hard to measure and the risk of being appealed against therefore increases. This is why the audit fee is the only factor that is considered in their procurement process even though their procurement document states that the audit fee shall only have a weighting of 20 percent and competence and experience shall be weighted with 40 percent.

This case can be related to Jobber (2001) and Beattie et al., (1998) who argues that price is the most important factor when competing with a service and even though the procurement documents weighted audit fee relatively low, these studies are applicable in this case since it seems like audit fee is the decisive factor. The Municipal Act states that the professional auditors must possess knowledge and experience in municipal operations and the Law of Governmental Procurement states that municipalities shall choose between the firm with lowest audit fee or the economical most favourable actor. Our interpretation is that it is more difficult for the municipal audit board to evaluate the economical most favourable professional audit firm since qualitative criteria are difficult to measure, therefore the audit fee is the basic factor when municipalities switches professional audit firm. From without this our interpretation is that the procurement document is more of a theoretical ambition, rather than a practical implementation.

### **6.3.1 Audit fee versus quality**

Three of twelve respondents have mentioned the trade-off between audit fee and audit quality and that these criteria are difficult to weigh against each other. Since the audit process is financed by tax money it is important to secure that the assignments are well

performed and that the cost of hiring professional auditors does not exceed the budget. This will although increase the risk for low audit quality and it is up to each municipality to make a weighting of these criteria, which will serve as a base for a well-conducted procurement. One of the respondents, a chairman of the municipal audit board believes that audit quality is the most important factor when switching professional audit firm. Therefore the economical most favourable firm shall be chosen instead of the firm with the lowest audit fee. An efficient professional auditor will perform the assignment more efficient and carefully and therefore he or she might be more cost effective over time. We asked the chairman of the municipal audit board from the municipality were the audit fee is the only considered factor if hiring the professional audit firm with the lowest audit fee will jeopardise quality. The answer we got was that he had not thought about this, but after some consideration he states:

*“Since we got the same amount of hours to a lower audit fee, this has probably resulted in lower audit quality.”*

The trade-off between audit fee and audit quality can be related to Gregory et al., (1996) who argues that audit fee reduction is on the expense of audit quality. Gregory et al., (1996) believe that a cut in audit fees is achieved by reducing the number of hours spent on the review, performed by a professional audit firm. Our interpretation is that there might be a trade-off between audit fee and audit quality, this interpretation is although rather vague since it is only mentioned by three respondents.

The chairman of the municipal audit board who believe that quality is the most important factor and one CFO in another municipality are critical of that there are trustee auditors that do not have the experience and knowledge that is required for a procurement process. Their lack of competence makes it more difficult to clarify the criteria and evaluate the quality of the professional audit firms. Further on, the CFO argues that the procurement document must be well developed to overcome the problem with the trustee auditors being too focused on audit fee. The CFO also believes that it is important to angle the procurement document towards the criteria they find important when switching professional audit firm but since audit fee is the easiest criterion to compare among in a procurement process, this is often used to the detriment of audit quality. The chairman of the municipal audit board expresses his scepticism about the trustee auditors:

*“... it is ordinary people who attempts to perform a board assignment that they do not understand.”*

*“Trustee auditors are not capable of judging audit quality”*

These quotations are confirmed by another chairman of a municipal audit board. He argues that the municipal audit board that he takes part in, is relatively inexperienced and they received advice from an internal department to minimize the criterions to ease the evaluation process.

These opinions and experiences can be related to Deis et al., (1992) who agree of that service quality is a complex variable to measure. As mentioned above, the procurement document must be well developed in order to catch the qualitative criterions and this is, as some of the respondents argue, a complex assignment (Svenska Kommunförbundet et al., 2001, SKL, 2010c). Our interpretation is that it is of importance that the trustee auditors, who develop the procurement document, have the right education and knowledge in the subject. If the above is not possible to achieve, we believe that one alternative could be to develop a “best-practise” between municipalities in Sweden/counties i.e. implement procurement documents from successful procurement processes for inexperienced municipal audit boards to follow. If the procurement documents are not developed in detail, there is a risk that the audit fee will be the only decisive factor when switching professional audit firm which is to the detriment of audit quality.

Nine of twelve respondents do however not believe that audit fees have any implicit effect on audit quality. They argue that the large professional audit firms have a reputation and standards of quality to live up to. If the professional audit firms do not fulfil these quality requirements, they will not receive any contracts in the future.

These beliefs are in line with Molander (2009) who have studied the procurement process of several services in the municipal sector in Sweden. Molander (2009) did not find any empirical evidence for that the service quality is jeopardised when a service with a low price is procured. Our interpretation of the respondent’s attitude is that, since the actors in the municipal audit sector have high standards of quality to live up, the

procurement document is trusted upon to overcome this gap between audit fee and audit quality. We believe that this interpretation is further strengthened since audit quality is seen as equal between the professional audit firms active in the municipal sector in Skåne.

### **6.3.2 Differences between the professional audit firms**

All respondents agree of that there are almost nonexistent differences between the largest professional audit firms within the municipal sector. The former dominance from PwC/Komrev has, according to all respondents, diminished and their competitors possess the same competence and knowledge and are therefore to be seen as equals.

The respondents although agree of that there are too few actors in the municipal audit sector and it would be of benefit for the municipalities if there were more competitors in the sector. This is something that is brought up during the interviews without us asking about it. The respondents are aware of that the smaller firms do not possess the same knowledge and resources to be able to compete on the same terms as the large firms. To allow more professional audit firms to operate in the sector, the municipalities are open for hiring the smaller firms for particular services. The three chairmen of the municipal audit boards argues that all audit firms are competent regarding the financial audit, therefore, to divide the municipal audit into a financial- and a management part might help smaller audit firms to enter the market. This might result in an increased knowledge of the municipal operations and the function of a municipal audit. This will lead to an increased competition among the professional audit firms within the municipal sector. All of the respondents believe that this increased competition will probably put pressure on the professional auditors to develop the audit procedures even more.

This can be related to Baker (2004) who argues that more actors in a market will help the competitiveness and offer the customer more alternatives. This is the common belief of all respondents who thinks that a more competitive market will help the municipalities to achieve new procedures in the audit. Baker (2004) argues that the competition on the provider side will lead to benefits for the consumer. A higher market concentration will result in lower audit fees according to Baker (2004) and in the

municipal sector lower audit fees, which according to Molander (2009), will *not* lead to lower quality. The respondent's argue that by open up the market when trying to get more firms in the municipal audit sector will lead to higher competition in the municipal audit market. Our interpretation is that there is a great desire from the municipalities' side that more professional audit firms shall enter the municipal audit sector. This since higher competition will probably result in that increased audit quality can be achieved at the same time as the municipalities will be offered more competitive audit fees. This might although be difficult since the procurement document require that the procured professional audit firm shall poses experience in the audit area (see figure 2). Also, to gain experience, municipalities must give the smaller audit firms audit tasks to conduct, which has yet not occurred in the interviewed municipalities. This implies that theory and practice is not equal.

#### **6.4 Signalling the use of a certain professional audit firm**

One chairman of the municipal audit board mentions that a municipality does not need to signal the usage of a certain professional audit firm in the same extent as in the private sector. He argues that the main objective in the private sector is to generate profit. The main purpose of the municipality is to establish and sustain an organisation that have well functioned routines and procedures to support its citizens (see figure 3) which is confirmed by Johnsen et al., (2004). This perspective with the private sector is only mentioned by one respondent who find it important to clarify the difference.

This opinion deviates from the theories by Beattie et al., (1998) and Campbell et al., (2001) who believe that a municipality will gain credibility by signalling the contract with a well established professional audit firm since this will signal high audit quality and credibility. Five of twelve respondents believe that this might depend on that many of the municipalities stakeholders find the financial reports complicated to understand since they do not hold an operational- and financial knowledge. This is confirmed by Hanberger et al., (2005) and discussed further below.

	Municipal Sector	Private Sector
Objective	Operation	Profit
Mean	Tax	Operation

**Figure 3:** The purpose of the municipality respective corporations in the private sector.

All respondents do agree of that the audit can be used as a tool to show citizens how tax money is distributed, and as one chairman of the municipal executive board states:

*“The audit is a guarantee for the citizens that the operation is in order”*

With this quotation the respondent refers to the municipal audit which is in line with Soltani (2007) who argues that the municipal audit will convince stakeholders that the operations are in order. Our interpretation is that even though the switch of professional audit firm is not used as a signalling tool towards the citizens, there is a thought that the municipal audit can be used to signal that the operations are in order and that the audit is performed with high audit quality towards the stakeholders. Due to the equality of audit quality and specialization of the three leading professional audit firms in the municipal sector in Sweden, based on the results from section 6.2, our interpretation is that there is low signal effect with the switch of professional audit firms. We believe that the municipalities that have an internal audit department might achieve a signalling effect if they switch from internal audit department to the use of a professional audit firm. This since a professional audit firm might contribute with a higher level of legitimacy.

All respondents believe that media have a large impact on what is signalled to citizens since they can understand the financial reports more easily than someone who does not possess financial- and operational knowledge. Through media the citizens within the municipality can gain an understanding about for example how tax money is used. Media has a critical reviewing role to meet and therefore media is considered a party that municipalities wish to cooperate with. This they do by inviting media to the municipal council where the results of the audit are presented and through press

conferences. How good media is as a signalling tool depends on how well media mediates the results of the audit to the citizens. If the wrong message is sent to the citizens, this will damage the municipality. As one chairman of the audit board said:

*“The media is only interested in reporting news that could raise profit, they look for front side news that sells copies.”*

No one of the respondents believes that media will communicate the switch of professional audit firm to the citizens if no scandal is involved in the switch. This because citizens do normally not care about what professional audit firm that is used, they do rather care about that their tax money is used in a proper way.

This is in line with Hanberger et al., (2005) who concludes that financial reports are rarely used by citizens since they are too complicated to understand. Therefore media is seen as one of the most important reviewers in a municipality since they can more easily understand the economic language. Campbell et al., (2001) believe that the politicians will signal what they think will give them credibility, which can be achieved by disclosing the information in the financial statements. Our interpretation is that even though the switch of professional audit firm is not used as a signalling tool, the information in the financial reports is obvious of importance. Therefore the municipal audit is an important signalling tool towards citizens. We believe that this is further strengthened since municipalities invite the press to the municipal council where the results from the audit are presented.

#### **6.4.1 Legitimacy**

All respondents believe that a professional audit firm that meets the requirements that are demanded in the procurement document is a partner that is legitimate. Legitimacy is although not achieved by the switch of professional audit firm or by signalling through the financial reports, legitimacy is achieved through proper actions.

This can be related to Coicaud et al., (2002) and Suchman (1995) who argues that politicians have a need to reflect a good behaviour that is in line with norms and values in society and by contracting professional audit firms with high reputation, the politicians will, according to Tilling (2004), gain legitimacy. According to Guénin-

Paracini et al., (2010) auditors can convince society that certain behaviours are legitimate and the Big Four have more channels to be legitimate. Their large organizations can easier communicate a good behaviour than smaller firms, they do also signal higher audit quality than smaller firms which will provide municipalities with legitimacy if they are hired (Chang et al., 2008; Coicaud et al., 2002). Our interpretation is that a switch of professional audit firm is probably not conducted to achieve legitimacy from society. The switch is probably due to other factors, such as audit fee etc but it is though important to procure a professional audit firm that is seen as legitimate. We believe this is further strengthened since all municipalities in the Region of Skåne procure their audit services from one of the leading professional audit firms (figure 1) which are seen as legitimate actors since they signal high audit quality (Chang et al., 2008; Coicaud et al., 2002).

One chairman of the municipal audit board argues that the professional auditors can contribute to the boards becoming more effective, which in turn may lead to legitimacy of the politicians. He also claims that hiring a professional audit firm with high reputation might contribute to higher trust among the employees towards the professional audit firm, which will signal legitimacy internally. This opinion is shared by one CFO who believes that the switch of professional audit firm may not have any signal effect to the citizens but there are though internal signal effects by the switch. When new professional auditors are contracted, these might improve processes within the operations which in turn can signal to the employees within the municipality that their work is more efficient.

This can be related to the legitimacy theory where behaviour that are in line with values and norms in society creates legitimacy (Suchman, 1995). Suchman (1995) argues that an organisational legitimacy is only retained if all performed actions are legitimate. Coicaud et al., (2002) argues that politicians are the ones that need to express proper actions to gain external legitimacy, therefore it is important that the politicians believe that the switch of professional audit firm will ensure legitimacy. This implies that to signal the switch of professional audit firm internally makes it possible that the switch will become legitimate on an external perspective. Our interpretation is that since the respondents believe that the switch of professional audit firm is more of an internal signal instrument and that the services that the professional audit firm provide are more

of an internal audit, this might lead to that the performed actions will gain external legitimacy as well.

## **6.5 Commitment**

All respondents believe that the business relationship plays a major role when deciding about switching professional audit firm. The trustee auditors are the ones that have a close business relationship with the professional auditors and therefore this might make it harder to switch professional audit firm. This is also something that one chairman of the municipal executive board agrees on, he believes that even if you are in a position to be reviewed, a dialogue and a mutual understanding of their assignments are of importance. One chairman of a municipal audit board comments that it is impossible to be totally objective in the procurement:

*“Of course the laws are considered but we are only humans and a subjective evaluation of the professional auditors during the procurement plays a major role for the outcome.”*

One chairman of the municipal audit board refers to a previous relationship with a client manager of one professional audit firm. This client manager was an important part of the relationship and the personality and engagement of the manager had a large influence of the procured services. The client manager signed off from the professional audit firm and the new client manager were not as engaged in the assignment, which lead to that the trustee auditors did not feel the same commitment as before. This was one factor that had an impact on their switch of professional audit firm. The same situation occurred in another municipality. The chairman of the municipal audit board in this municipality also refers to the importance of commitment in a business relationship. Their old client manager had a long business relationship with the municipal audit board. After his retirement, the successor did not show the same engagement and did not deliver a satisfying audit quality. The chairman of the municipal audit board believe that the lack of commitment made it easier for the trustee auditors to break off the long business relationship and switch to another professional audit firm.

These experiences is in line with Moormen et al., (1992) who argues that a business relationship will continue as long as it creates value, which is defined as commitment in

the business relationship. This implies that commitment and a strong business relationship is very important if the relationship is to last into the future, a mutual trust between the trustee auditors and the client managers in particular is essential when building a business relationship. The respondents also believe that it is easier to build a strong business relationship with few persons, which is confirmed by Jones et al., (2009) and Carrington et al., (2007). Our interpretation is that when a client manager, to which the trustee auditors have had a satisfying business relationship, lay off the assignment there is no value left in the business relationship and it might therefore be easier to switch professional audit firm.

One CFO argues that it is easier to switch professional audit firm if you are dissatisfied with your relationship with the client manager and the professional auditors. This CFO and one chairman of the municipal audit board in the same municipality argues that their switch of professional audit firm was easy since they were dissatisfied with their relationship with the client manager in the old professional audit firm. This was also the main reason for the switch. They also argue that if the situation was the opposite, it would probably be more difficult to switch professional auditors. The chairman of the municipal audit board, mentioned above, refers to the procurement of a professional audit firm as an interview with a presumptive employee. He equalizes the relationship with the professional auditors with the relationship to an employee within the municipality. He believes that personality and the required technical qualifications are important if the relationship is to last but the technical credentials is not the essential factor.

As mentioned above, the respondents emphasizes that a well functioned business relationship is necessary for a well-performed audit review. This is in accordance with theory about commitment. Moormen et al., (1992) argue that a business relationship will continue as long as it creates value. It is important that the professional audit firms consider the needs of their client very carefully. With the strong competition that we face today, technically qualifications is not enough (Addams et al., 2002). Our interpretation is that if a municipality is satisfied with the client manager and the professional auditors and if they feel that they have something to gain, the relationship will last. In opposite, if the municipality is dissatisfied with the client manager or the trustee auditors, even if they have the technical qualifications, they will switch to

another professional audit firm. The impression we got during the interviews were that if the municipalities can ignore the Law of Governmental Procurement and chose a professional audit firm they believe will deliver a satisfying business relationship, they will do this. One reason for this might be that the dominating professional audit firms are seen as equal regarding audit quality and therefore the municipality can more critical evaluate the business relationship as one important factor. This further strengthened our belief that commitment might be very important when switching professional audit firm. From the reasoning above, it might be desirable to develop a variable within the procurement document where business relationship can be measured as a compliment to the current audit fee dominance.

### **6.5.1 Change in government**

When asking the respondents if political competition or change in government and political majority has an impact on the switch of professional audit firm, all respondents agree of that this does not have any impact. The respondents argue that even if the professional auditors act as an intermediary between the citizens and the politicians they do not see any reasons to switch professional audit firm as a result of political competition or change in government and political majority. They argue that there is no political agenda with the audit, which is important since it is the boards that shall be reviewed and the municipal audit board shall be separated from the boards.

This deviates from theory, which concludes that when the manager director is switched there will also be a switch of audit firm which is based on the lack of relationship between the new management and the old audit firm (Hudaib et al., 2005). Baber (1983) concludes that the complexity in the political market makes it difficult to determine what incentives politicians have when they switch professional audit firm. He also argues that the switch in some part is affected by political competition (Baber, 1983). This is confirmed by Blank et al., (2009), who concludes that audit fees rise with rising political competition in the municipal sector in Sweden. As we carried through with the interviews we realized that the respondents were very political correct. Some of them took long time before they answered, which we believe depends on that they thought through the questions carefully in order to be as political correct as possible. This might be a result of that, as Carpenter et al., (2001) claims, that the politicians will signal what

they think will give them credibility. We interpret the above reasoning as an indicator of that there might be political incentives with the switch of professional audit firm which is further strengthened since audit fee rises with political competition (Blank et al., 2009) and as interpreted in section 6.3, audit fee affects the switch of professional audit firm.

One CFO and one chairman of the municipal audit board in one municipality states that they switched professional audit firm when the municipal audit board was replaced. The switch of professional audit firm was easier since the new municipal audit board did not have a relationship to the old professional audit firm. Another chairman of a municipal audit board although argues that a switch of professional audit firm and municipal audit board at the same time will result in lost knowledge about the operations.

This case implies that theory about change in government (Hudaib et al., 2005) might be applicable regarding when the municipal audit board is switched. Since there are different purposes with the municipal audit in Sweden and the audit in the private sector it might be the case that the professional audit firm is switched when the municipal audit board is switched. This since it is the municipal audit board that work in close coordination with the professional auditors and therefore the lack of relationship will contribute to the switch of professional audit firm (Hudaib et al., 2005). This is although a rather vague interpretation since it has only occurred in one of the three interviewed municipalities.

## **6.5.2 Independence**

### ***6.5.2.1 Independence between the professional auditors and the trustee auditors***

It is important that professional auditors act independent and this is the general idea of all respondents. Further on, they are all of the same opinion that a switch of professional audit firm on a regular basis will keep high independence of the professional auditors. Two of three chairmen of the municipal audit boards share the experience of having the same professional audit firm over a long period of time which resulted in that the professional auditors became too comfortable and too sure of the continuation of the contract in the future. One chairman of the municipal council states that one of the

reasons why their municipality switched professional audit firm was because of lack of independence. This was a result of a long-term business relationship where the professional auditors and the trustee auditors had become too close to each other which can be seen as a threat to that the professional auditors do not act independent. All respondents believe that this will lead to lower audit quality and this is a strong reason to why their municipalities switched professional audit firm.

These thoughts and experiences are in accordance with Raiborn et al., (2006) and Sinnet (2004) who concludes that an unlimited period of association between an audit firm and their client is a threat to independence, which will be eliminated with audit firm rotation. Raiborn et al., (2006) argues that there are strong incentives for the auditor to act the way the client wants even if dubious accounts are approved, which will lower the audit quality and independence is jeopardized. Fewer adjustments will result in a less expensive audit process which will satisfy the client and the audit firm will probably retain the client (Raiborn et al., 2006). Our interpretation is that independence in appearance of the professional auditors is an important matter when the decision about the switch of professional audit firm is taken. The indications that we have received is that independence will contribute with higher audit quality and thereby increased reliability of the financial statements. Also, in order to gain increased audit quality, it might be beneficial to switch professional audit firm in order to avoid comfortable behaviour from the professional auditors.

In one municipality, the chairman of the municipal audit board and the chairman of the municipal executive board believe that there might be an independency problem between the trustee auditors and the professional auditors that will affect that the professional auditors do not even act independent. Both respondents believe that the professional auditors are too dependent on the trustee auditors in order to gain new assignments. They are also critical to that the audit assignments are under the control of the trustee auditors. They have both seen tendencies that this independency problem between trustee auditors and professional auditors exist in their municipality. The chairman of the municipal executive board expresses:

*“All professional auditors’ acts as consultants and they are too dependent of the trustee auditor’s opinions. Their willingness to gain new assignments can inhibit the quality and bias the audit performed in the municipality.”*

This is in line with Hanberger et al., (2005) who argues that it is doubtful whether or not independence has been strengthened since the trustee auditors and the professional auditors work in close coordination with each other. Cassel (2000) and Pott et al., (2009) argues that the audit process within a municipality is restricted by guidelines from the contractor which result in that the professional auditor do only act independent, they are not independent in fact. Our interpretation is that even if the professional audit firm is switched from time to time, the professional auditors will still not be independent in fact and sometimes they will not even be independent in appearance since they are too dependent on the trustee auditors in order to gain new assignments.

The above mentioned respondents believe that this independency problem is difficult to overcome because there are different opinions about how controlled or how willing the professional auditors are to please the trustee auditors. A solution to this problem would, according to the chairman of the municipal executive board, be that the audit process in a municipality only are to be performed by professional auditors, which is something he advocates highly.

#### ***6.5.2.2 Independence between the professional auditors and the boards***

All respondents except the three chairmen of the municipal audit boards agree of that the audit process is separated from their assignments within the municipalities. They point out that independence must be maintained and since they belong to the boards that will be reviewed, they shall not have any opinions about the audit review. One chairman of the municipal executive board express:

*“It is important to not have any opinions about the audit review since they do not want a reputation that they do not like to be reviewed.”*

All respondents believe that independence is maintained between the boards that will be reviewed and the professional auditors since it is the trustee auditors that have contact with the professional auditors on a regular basis. Besides the three trustee auditors, the other nine respondents do only have contact with the professional auditors once or twice a year in order to discuss the closing of the books. Two CFO's although states that they

contribute with advice when the trustee auditors are uncertain in some issues regarding the process of evaluating a professional audit firm in a procurement process.

#### 6.5.2.2.1 Independence between the trustee auditors and the boards

The chairman of the municipal council, the chairman of the municipal audit board and the chairman of the municipal executive board in the same municipality do *not* believe that the trustee auditors are independent towards the boards that will be reviewed. The reason why they think that the trustee auditors are not independent is because it is difficult for the trustee auditors to distinguish between an ordinary committee assignment and the work of the municipal audit. Therefore there is party politics involved in the audit. The three respondents believe that it is important to switch trustee auditors in order to maintain independence.

This is in accordance with the arguments by Blank et al., (2009), that there is a danger of independence since the trustee auditors are selected among politicians, which is equal to that the auditors in the private sector is selected among the board members. Our interpretation is that since the professional auditors are hired by the trustee auditors, the professional auditors are not either independent towards the boards since they receive their assignments from the trustee auditors and might therefore be affected by party politics.

The other nine respondents do although not believe that there is any party politics involved in the municipal audit. They believe that the trustee auditors are professional enough to keep party politics outside of the audit. One chairman of the municipal audit board states:

*“my opinion is that the trustee auditors are aware of the requirement for independence”*

No one of the respondents see any problem with the trustee auditors becoming too comfortable in their assignments because of the knowledge they will gain with the experience of their time in the municipal audit board. They think that experience in the municipal audit board will help them to become more cost effective when constructing assignments and it will contribute with higher audit quality. One chairman of the

municipal council mentions that the municipal audit board are the ones that must be best suitable to construct the assignments. He although argues that the municipal council must take its responsibility and help the audit board to find audit assignments.

This is in line with the opinion of opponents of audit firm rotation, client-specific knowledge will prevent the effectiveness of the audit process (Lu et al., 2009; Raiborn et al., 2006; Gómes-Aguilar et al., 2003). Our interpretation is that it is important that the trustee auditors have the specific knowledge needed for the assignment in order to be more cost effective and contribute with audit quality. This is in contradiction to the professional auditors where it is more important for the professional auditors to be perceived as independent since this will increase audit quality (see section 6.5.2.1) and thereby they have to be switched from time to time. Our interpretation is that it is a switch of professional audit firm, rather than a switch of trustee auditors, which contributes to that the audit review is perceived as independent.

## 6.6 Summarizing table of respondents attitudes

	Factors that affect the switch of professional audit firm	Factors in the procurement document	Underlying factors
Audit fee	High	X	
Audit quality	Low	X	
Signalling	Low		X
Legitimacy	Low		X
Commitment	High		X
Change in government	Low		X
Independence of the professional auditors	High		X

**Table 1:** This table summarizes the respondents attitudes towards what factors that affects the switch of professional audit firm. Low is defined as 0-4 respondents in favour, medium as 5-8 respondents in favour and high as 9-12 respondents in favour.

## **7 Conclusion**

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*In this chapter, our conclusions are presented which are based on the aim of this thesis. This is followed by our theoretical contribution, observations and reflections, criticism of the study and further research.*

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### **7.1 End discussion and conclusion**

The aim of this master thesis is to *create a better understanding for what factors and why these factors affect a switch of professional audit firm in the municipal sector in Sweden*. In a first phase it may seem simple to understand why a switch of a professional audit firm occurs since the procurement process are regulated in laws which affect the procurement document. During our research we have come to understand the complexity of the switch. The procurement document specifies the basic qualifications of a professional audit firm which consists of two specifications, quantitative- and qualitative criterions. Our research shows that qualitative criterions are complicated to use as selection criterion since they are difficult to measure and thereby the risk of being appealed against increases.

In the analysis, we have found several factors that affect the switch of professional audit firm in the municipal sector in Sweden. It appears that the respondents generally agree of what factors that affect the switch. What is considered to be the main reasons for why a switch of professional audit firm occurs is presented below.

#### **7.1.1 The research question is answered**

The research question was specified in the first chapter: *Why do municipalities switch professional audit firm?* In the analysis we can distinguish three factors that have an impact when municipalities switches professional audit firm. These are: audit fee, commitment and independence of the professional auditors.

During the study we have discovered that even though the majority of the respondents do not explicitly refer to audit quality as an important factor, it reoccurs as an essential factor throughout the study. We have also realized that commitment and auditor independence is in contradiction to each other. This since commitment is about having a close business relationship, something that affects the independence of the professional auditors in a negative way.

The analysis shows that **audit fee** is the decisive factor when a municipality switches professional audit firm even though the procurement documents in these cases do only weight audit fee between 10-30 percent. The fact that audit fee is a quantitative factor plays a major role since it is easier to measure and thereby compare. Some respondents have mentioned the trade-off between audit fee and audit quality and that these criteria are difficult to weight against each other. Since the audit process is financed by tax money it is important that the audit review is well performed but the cost of hiring professional auditors shall not exceed the budget. These respondents believe that this will increase the risk that the audit is performed with low audit quality. The majority of the respondents do not believe that audit fee has any implicit effect on audit quality. This since the professional audit firms that belong to the Big Four have a reputation and standards of quality to live up to which makes the firms equal regarding audit quality. Further on, since audit fee is a quantitative criterion it is easier to evaluate than qualitative criteria and therefore the decisive factor when the tenders are equal.

In the analysis, we can also distinguish the importance of **commitment**, business relationship and personal chemistry when municipalities switch professional audit firm. Since it is the trustee auditors that have the foremost contact with the professional auditors it is of great importance that this relationship is well functioned. Some of the respondents believe that lack in commitment and a bad business relationship will lead to unsatisfied audit quality. The importance of a business relationship and a personal chemistry is also confirmed by positions that will be reviewed within the municipality. They believe that it is important that they are able to have a dialogue and a mutual understanding for the assignments. The personality of the professional auditors plays an increasing role, especially when there are difficulties to distinguish the firms' from each other, regarding specialization and audit quality. The downside with this factor is that it is hard to make criteria of what the municipality is demanding and it will in turn

make it harder for the municipality to be objective in their selection. Personal relationship is a qualitative criterion, which is difficult to evaluate since people do not always have the same beliefs and share the same view regarding how a person is perceived.

Another substantial factor that is found in the analysis is the importance of the professional auditors acting **independent**. By switching professional audit firm on a regular basis will contribute to increased independence of the professional auditors. By having the same professional audit firm over a long period of time might result in that the audit is not perceived as independent, it might also result in lower audit quality as a result of decreased independence. This since the professional auditors may become too comfortable when it comes to their assignments. The professional auditors will also be too dependent on the trustee auditors in order to gain new assignments.

In summary, we conclude that there are four factors found in this study that have an impact on why municipalities switches professional audit firm. The most important qualitative factors are **commitment** and auditor **independence**. Municipalities switch professional audit firm because of a non-functional business relationship and the lack of auditor independence which in turn will lead to poor audit quality. Therefore we also conclude that **audit quality** is an important factor when switching professional audit firm. The most important factor is though in general **audit fee**, which tends to be the decisive factor when the tenders are equal. This is probably a result of that that quantitative factors are easier to measure.

7.1.1.1 Concluding factors that affect the switch of professional audit firm

	Factors that affect the switch of professional audit firm, according to the respondents attitude	Concluded factors that affects the switch of professional audit firm
Audit fee	X	X
Audit quality		X
Signalling		
Legitimacy		
Commitment	X	X
Change in government		
Independence of the professional auditors	X	X

**Table 2:** The left column shows what factors that the respondents expresses to affects the switch of professional audit firm. The right column shows what factors that we conclude to be affecting factors to why a switch of professional audit firm occurs.

7.1.2 Theoretical contribution

Since most theory and previous research is conducted in the private sector or in the municipal sector in foreign countries, we have found deviations between our empirical results, theory and previous research. We believe that these deviations are mainly due to that there are different purposes with the audit when you compare the municipal sector in Sweden with the private sector in general and the municipal sector in foreign countries. In Sweden the main focus with the audit is managerial audit while the main focus in the private sector and in the municipal sector in foreign countries is financial audit.

Beattie et al., (1998) concludes that the contract with a well established professional audit firm will *signal* high audit quality and honesty. Our empirical results imply that politicians will signal what they think will give them credibility, such as increased audit quality, the switch of professional audit firm is not seen as a credibility increasing factor. In Sweden, citizens are mainly interested in that tax money is used properly, therefore there is no information value in the switch of professional audit firm as long as it do not affect the use of tax money significantly. Also, the low signalling effect might

depend on that audit quality and specialization is seen as equal between the three large professional audit firms.

Hudaib et al., (2005) concludes that when the manager director is switched, there has also been a switch of audit firm. This deviates from our empirical results which indicate that there is no political agenda within the audit. Our empirical results although indicates that the professional audit firm might be switched when the municipal audit board is switched. This since they are the employer- and work in close coordination with the professional auditors.

## **7.2 Reflections and observations**

During the interviews, we experienced that the respondents were very political correct in their answers. This was especially discovered when we asked the respondents about the political influences within the audit. The respondents agree of that there are no political agenda within the audit but since Blank et al., (2009) conclude that audit fee is affected by political competition we believe that there might be a political agenda. This is although not proved in our empirical results but since we conclude that audit fee is the decisive factor when the professional audit firm is switched there might be political incentives with the switch.

One reflection of our study is that there are few actors within the municipal audit sector. The respondents would like to see increased competition on the audit market since this would probably lead to increased audit quality since new actors might bring new ideas regarding how to improve the audit in the municipalities. This is in accordance with Baker (2004) who concludes that more actors will increase the competition which will give the consumer more alternatives to choose among.

Another reflection of our study is that the audit might serve more as an internal instrument instead of an external. The findings from our interviews clarify that the audit performed by the trustee auditors are to be seen as an internal development of procedures that sends signals to the employees within the municipality instead as a signalling tool to the citizens. This is concluded by Cassel (2000), which support that the external view is not the main focus in the municipal audit process.

During the interviews we found interesting subjects that are not in line with the research question which we though find important to reflect. One reflection is that two of three chairmen of the trustee auditors do not have, according to themselves, sufficient political experience for their assignments. Trustee auditors are often ordinary people who have poor knowledge of generally accepted auditing standards and are therefore not qualified to perform a proper audit (Collin, 2008). SKL (2008b) has done interviews about the audit that is preferable in municipalities and in the county council. A weakness that has been emphasized is the ineffective nomination process which can result in that people with no competence gets elected to serve as trustee auditors. (SKL, 2008b) We find this quite remarkable since the chairmen of the trustee auditors themselves question if this system with trustee auditors is the best to be used.

### **7.3 Criticism of the study**

The study is conducted in different municipalities in the Region of Skåne and since they belong to the same region, a special culture may characterize the municipalities. This may explain why the answers are quite similar. The results may have turned out differently if we had chosen to interview additional respondents that have a greater impact on the switch of professional audit firm or if we had interviewed respondents from municipalities outside this region.

### **7.4 Further research**

In order to gain a deeper understanding and make an overall assessment of what factors that have an impact when municipalities switches professional audit firm, a more comprehensive study of all municipalities in Sweden are preferable. Further on, it would be interesting to interview respondents from the professional audit firms to capture the sellers' perspective of the phenomenon and see if they have the same interpretation of which factors that have a large impact in a procurement process.

Several of the respondents have, as mentioned in the previous section, stated that the trustee auditors do not possess the right competence for their assignments and that there should be an evaluation of the suitability of the trustee auditors' role in the procurement process. It can be interesting to perform a study whether or not the competence among

the trustee auditors is sufficient to, for example, make a decent evaluation of what criteria that the professional auditor shall be judged after.

Some respondents believe that lower audit fee of the audit will lead to decreased audit quality. There is a common belief that lower audit fee leads to auditors with less competence perform the audit. Therefore it is suitable for further research to study if quality change in relation to the audit fee.

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## **Appendix 1**

### **SURVEY QUESTIONS**

- Which professional audit firm do you use when you need expert help within the audit?
- Which professional audit firm did you use 2004 respective 2008?
- How often do you procure this type of service?
- Which persons within your municipality do you believe have insight in the municipal audit?
- What is your role regarding the municipal audit?

## **Appendix 2**

### **INTERVIEW GUIDE**

#### **INTRODUCTION QUESTIONS**

- Describe your work and particular role within the municipality.
- Describe your role in the procurement process.
- What factors do you think affect the audit within the municipality?

#### **SIGNALLING AND LEGITIMACY**

- What stakeholders are there within the municipality and is there an interest of the audit among these stakeholders?
- How do you communicate with the stakeholders?
- How do you perceive the role of the audit within the municipality?
- Do you think that audit has a signaling effect towards the citizens?

#### **COMITTMENT**

- What characteristics do you believe a professional auditor shall possess?
- How important is the relationship to the client manager?
- What impact does political competition have within the municipality regarding the municipal audit?
- How is the relationship between the government and the trustee auditors?
- What do you believe characterizes an independent audit within the municipality?
- How important is independence from the professional auditors?

#### **AUDIT FEE, QUALITY AND SPECIALIZATION**

- Give us your reflections about how the procurement process is performed.
- What is your opinion about the effect that price has on the decision?
- What qualifications do you see as most preferable of the professional auditors?