

Working Paper Series 2006:6

What Do Auditors Do? Obviously they do not scrutinize the accounting and reporting

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ABSTRACT

Previous research has shown that compliance with accounting standards in Swedish municipalities in general is poor. Auditors and auditing firms are important actors in the process of institutionalising accounting standards. Auditors' credibility relies on their ability to appear as professional and independent. However, the formal and institutional requirements to de facto ensure professionalism and independence in the Swedish municipal sector have been strongly questioned. The aim of this study is to examine the auditors' role and responsibility for the poor compliance with accounting standards in Swedish municipalities. The results expose large shortcomings of the audits of Swedish municipalities. The auditors seldom or never make any remark on deviation or violation of the accounting standards in their auditing reports. This indicates that the current formal and institutional settings do not support professional and independent auditing of Swedish municipalities. The auditors seem to ally themselves with the auditees in a fabrication, in order to induce a false belief to the public. The involvement of the auditors in the deception is essential in order to give "comfort" to the contained stakeholders. Thus, the institutionalisation of new accounting standards does not benefit from the normative and coercive pressure from the auditors.

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Introduction

The regulation of Swedish municipal accounting has gone through fundamental changes over recent decades. From a more or less voluntary regulation, municipal accounting moved after 1 January 1998, to one regulated by law. This law, the Municipal Accounting Act (KRL 1997:617), is only framework legislation, but the referencing to standard setting bodies in the wording of the law and in the preparatory legislative work has increased the importance of standards, decrees and guidelines from regulatory bodies. The Council for Municipal Accounting is the main standard setter in local government accounting and responsible for development and interpreting of generally accepted accounting principles (GAAP) for the municipal sector. It is an independent, non-profit organization whose members are the Government, the Swedish Association of Local Authorities, and Regions. It was established at the same time as the Municipal Accounting Act came into force in 1998. Its function is to develop standards for accounting issues where the specific nature of the municipalities must be taken into consideration. Besides representatives from the founding members, the board and the expert committee consist of representatives from the academy and the accounting and auditing profession. According to the Municipal Accounting Act, GAAP should be followed; deviation from accounting standards issued by the Council for Municipal Accounting should be reported in the annual accounts with a statement of reasons for the deviation.

Recent studies issued by the Council followed up on compliance with the accounting standards they have issued (Falkman, 2004; Falkman and Tagesson, 2005). Data on compliance were collected through a survey, a study of documents, and interviews. The overall results showed that compliance with accounting standards and legislation in general was poor; on average, the municipalities deviated from almost one-third of the standards issued by the Council. However, in the annual accounts it was very rare that municipalities reported on the deviations or the reasons for them.

Accounting is a social system and as such it tends to evolve by adapting to its environment (e.g., AICPA, 1973; Bergevärn, Mellemvik and Olson, 1995). This holds true for the 'norm system' (how things are supposed to be) and the 'action system' (how they really are) both of which have to relate to the institutional context (Bergevärn, Mellemvik and Olson, 1995; Brorström, 1997). Thus, the accounting action system can be influenced not only through the norm system but also directly from the contextual environment. A successful accounting reform – meaning that new institutional norms and standards are accepted – implies that old institutional norms must be given up. Old institutionalised norms have the power to survive even though they no longer are functional (e.g. Tolbert and Zucker, 1996;

Seo and Creed, 2002). According to Mellemvik and Olson (1996), this could be explained by the fact that many accountants have invested a lot of time and effort in learning the existing norm system and therefore actively oppose accounting change. Hence, it is rational that there is a looseness or gap between changes in the norm system and the accounting action system (Brorström, 1997). In order to overcome this loose coupling between norm system and action system it is important that authorities legitimise and support the implementation of accounting standards and other norms (Hussein, 1981; Jönsson, 1985). Previous research on the private sector shows that auditors and auditing firms are important actors in the process of institutionalising accounting standards (Jönsson, 1995; Touron, 2005). According to Lüder and Jones (2003) and Christensen (2005), international auditing and consulting firms also played a crucial role in the process of implementing accrual accounting in the public sector.

One possible explanation for the poor compliance with the Council's accounting standards (e.g., Falkman, 2004; Falkman and Tagesson, 2005) could be the arguments based on institutional theory that assume reluctance to change (cf. Tolbert and Zucker, 1996; Seo and Creed, 2002). Another possible explanation is that the audit quality in the municipal sector is not satisfactory. Audit quality is defined as the probability that the auditor will discover and report on shortcomings in the client's accounting system (DeAngelo, 1981; Deis and Giroux, 1992). The auditor is supposed to scrutinize the entity's accounting "... for the purpose of expressing an opinion on whether or not the financial statements provide a true and fair view of the entity's financial position and performance, and comply with relevant statutory and/or other regulatory requirements" (Porter, Simon and Hatherly, 2003:5).

In sum, auditors are an important group in the process of institutionalisation accounting standards. The group influences the norm system and regulation by representation in the standard-setting body as well as by their capacity to influence the observance of and compliance with the accounting standards in their role as auditors scrutinizing the accounting and reporting functions.

Insert Fig 1 about here

The aim of this paper is to investigate and explain how deviation from accounting standards issued by the Council for Municipal Accounting are treated and reported by auditors. The treatment of deviation in the accounting report can help us to better understand

how auditors influence the development of generally accepted accounting principles and institutionalisation of accounting standards.

Theoretical framework and institutional settings

The role of auditors

The traditional role of the auditor is to professionally and independently scrutinize the accounting and reporting in order to add to the reliability and quality of the financial reporting (cf. Cassel, 2000; Porter et al., 2003). Hence, the audit should protect the stakeholders and contribute to a trustful relationship between the agent (the auditee) and the organisation's principals and other stakeholders relying on the financial information. Without this scrutiny there is an increased risk that the agent will abuse the information advantages and power of trust in order to profit at the expense of the principals and other stakeholders (Zimmerman, 1977; Dunn, 1996). By judging and attesting the validity of financial statements, the role of auditors is to produce trust and give "comfort" to the public and other interested parties who are vulnerable to erroneous reporting, opportunism and fraud (e.g Pentland, 1993). According to Pentland (1993) auditing can be seen as a ritual which offers a sense of order and safety.

Confidence in the auditors relies on their ability to act professionally and independently towards auditees as well as towards stakeholders. To guarantee the auditors' professionalism and independence it is necessary to create institutions and regulations that prevent the auditors from allying themselves with the auditee in order to obtain advantages on behalf of the audited organisation's stakeholders (Bazerman, Morgan, and Loewenstein, 1997). Unless auditors are supposed to act differently compared to other agents, it could be assumed that auditors will act in order to maximize their own wealth and utility (Antle, 1982). The legal and institutional conditions influence the risk and opportunity to benefit at the expense of someone else. In the private sector the capital and credit markets put institutional pressure on the auditors (c.f. Pentland, 1993). In the public sector corresponding stakeholders that put institutional pressure on auditees and auditors do not exist (Zimmerman, 1977). Instead legislation and other institutional arrangement will have to secure the financial reporting and the independence of the auditors (ibid.). Cassel (2000) questions whether the formal and institutional settings will ensure a professional and independent audit within the Swedish municipal sector. If Cassel is right, there is a potential risk that the auditors and the auditees will ally with each other (Bazerman, Morgan, and Loewenstein, 1997) and the audit ritual will

be reduced to a ceremonial act, a fabrication, in order to induce the public and other stakeholders to have a false belief about what is going on (Goffman, 1974).

Auditor independence in local government

As mentioned above, previous research on the private sector shows that auditors and auditing firms are important actors in the process of institutionalising accounting standards (Jönsson, 1995; Touron, 2005). However, it is a more difficult task to assess the influence of auditors on implementation of accounting standards in the Swedish municipal sector. The reasons for this difficulty relate to the organization, authority, and responsibility of auditors in this sector. In general, there is no requirement on the professional auditing of local governments in Sweden. Instead, each municipality has an elected auditing body consisting of politicians. Their knowledge of accounting and performance measurement may vary considerably. Politically appointed auditors cannot be regarded as external or independent auditors (Cassel, 2000) but rather as a group of internal auditors whose responsibility it is to make sure that the municipal officials implement decisions actually made by politicians. In practice, the politically appointed auditors hire professional auditors from the big auditing firms as expert assistance. (We will refer to these experts as auditors in this paper.) Some of the big cities have their own audit offices where they employ their own experts to assist the politically appointed auditors. Chapter 9, section 8 in the Local Government Act states that: “The [political] auditors shall be assisted by the experts [professional auditors] in their inspection whom they have chosen themselves and use them to the requisite extent. The experts shall have the insight and experience of local government activities required to be able to carry out their assignment.” This arrangement is supposed to secure the auditing process regarding professional knowledge, but the audit can still be questioned from an independency point of view (Cassel, 2000). The arrangement whereby the political auditors choose experts themselves ‘opens up the market for opinion shopping’. This lack of external audit can have a negative effect on the implementation of accounting standards issued by the Council for Municipal Accounting. As the professional auditors only act as expert assistants to the politically appointed auditors in the work of auditing Swedish municipalities, they have limited potential to put coercive pressure on their clients with regard to their authority to decide whether the organisation will get a qualified auditor’s report or not (e.g., Meyer and Rowan, 1977). In the 1990s the professional auditors’ position was strengthened a little, when a section stating that “The experts’ [professional auditors’] report shall be enclosed with the [political] auditors’ report” was included in the Local Government Act (Chapter 9, section 16). However, this inspection

report is enclosed when the formal audit report is submitted to the assembly, but not included in the printed annual financial statements. As members of a professional group, the professional auditors can still be expected to put normative pressure on their clients in order to define the conditions and methods of their work (DiMaggio and Powell, 1983). The recognition of the professional auditors' perceived managerial and economic competence gives them status and legitimacy (cf. Christensen, 2005).

Competence

Specialisation and experience with a certain line of business increases effectiveness and quality of the audit (cf. Deis and Giroux, 1992; Coate and Loeb, 1997; Hogan and Jeter, 1999). Even though the legislation states that the professional auditors (experts) "...shall have the insight and experience of local government activities required to be able to carry out their assignment", there is no formal requirement of education with respect to academic courses in accounting, auditing or public administration. Since 1999, there has been an organisation called SKYREV (Svenska Kommunala Yrkesrevisorer—*Swedish municipal professional auditors*). To become a certified member of SKYREV, one must fulfil certain requirements concerning education and professional experience. Today approximately a third of the experts working as professional auditors in municipalities are auditors certified by SKYREV. However, it is still common for certified public accountants who are trained and educated for auditing companies in the private sector to be engaged as expert assistants to the political auditors. Culture and client portfolio may influence the audit habits of the professional auditors and models may by coincidence be diffused by the auditor (e.g., DiMaggio and Powell, 1983). Legislation and conditions differ between the public and private sectors. Therefore the use of professional auditors who are not trained and educated in public administration and public accounting may have a negative influence on audit quality.

Accountability and Legislation

Citizens and other stakeholders often lack interest in municipal accounting matters (Zimmerman, 1977; Bouckaert and Dooren, 2003). According to Zimmerman (1977), the voters (the principals) have little use for accounting information as there are restrictions on the sale of claims. Ownership cannot be concentrated in individuals willing and able to monitor the costs and benefits of public property. Furthermore, Zimmerman points out that there is no market for capitalization, which further reduces the principal's incentive to monitor the agent under public property rights. In addition, the politicians (the agents) will

prefer an accounting system which allows them to report selective subsets of information to different groups of voters (ibid.). According to Zimmerman, legislation is essential to obtain accounting change within the municipal sector:

... municipal accounting reforms will continue to be ignored until the reformers are able to specify changes in the institutional framework which provide different incentives for the public officials (or voters). The most obvious institutional change would be federal legislation... The impact of such legislation is, ultimately, an empirical issue. (Zimmerman, 1977: 134 – 135)

According to Cassel (2000), the regulation – or rather the lack of regulation – of auditing and auditors in local government can be questioned. There is no legislation that regulates the professional auditors' competence and obligations. Of course, there is a business-like accountability relationship between the professional auditor and the political auditors who engage them. But the stakeholders of the municipality cannot hold a professional (or political) auditor responsible. Hence the weak legislative framework, in combination with the stakeholders' little use for accounting information, may not help to stimulate professional auditors to promote the implementation of accounting standards issued by the Council for Municipal Accounting.

In sum, in light of the institutional arrangement – implying deficiency in independence, unclear claims of competence and lack of accountability – it can be expected that the role of the auditors in the implementation and institutionalisation of the accounting standards issued by the Council for Municipal Accounting has been relatively weak.

Method

The empirical data were collected through documentary study and interviews. The documents of interest were the professional auditors' inspection reports for the accounting year 2003 and the financial statements for year 2003. The remarks and comments in the inspection report have been reconciled with the deviations noted in the studies issued by the Council for Municipal Accounting relating to the same accounting year (e.g., Falkman, 2004; Falkman and Tagesson, 2005).

The documents were collected from a sample of 16 municipalities that in the former survey (ibid.) had reported that they consciously deviated from the Council's accounting standards, without reporting the deviation in the annual accounts with a statement of reasons.

The sample was limited and intentionally focused on municipalities that were aware that they did not comply with the accounting standards. This awareness could be the result of receiving remarks from their professional auditors or of doing nothing about the deviations and continuing to deviate without reporting reasons for the deviation (since the auditors did not discover and remark on the deviation). The municipalities in the sample were chosen to proportionately reflect the distribution of audit assignments among the big auditing firms.

The distributions of professional auditors were:

PricewaterhouseCoopers	9
KPMG	4
Ernst & Young	2
Own audit office	1

Since the empirical data is limited, we will be cautious in generalising from the results of this explorative study. However, the reliability of the results were strengthened in the round-table discussion we arranged with representatives from the three auditing firms, representatives from politically appointed auditors from different parts of Sweden and representatives from the Swedish Association of Local Authorities and Regions. At this round-table discussion we presented the empirical results from the documentary study. The ensuing debate dealt with the validity and reliability of the results together with a discussion about the professional auditors' professionalism and responsibility for implementation and institutionalisation of accounting standards issued by the Council for Municipal Accounting. We also did some individual interviews with professional auditors both from the group whose inspection reports we studied and with other professional auditors.

Results

The survey issued by the Council for Municipal Accounting (Falkman, 2004; Falkman and Tagesson, 2005) consisted of two parts. In part one, the chief accountant gave an opinion on whether the municipality deviated from any of the 14 accounting standards issued by the Council; and if so, whether the municipality reported the reasons for the deviation in the financial statements. In part two, the chief accountant had to answer a number of questions on how different accounting matters were treated. Hence, this second part could reveal further deviations from the accounting standards issued by the Council. On average, municipalities

deviated from 3.89 accounting standards out of 14 (Falkman and Tagesson, 2005). The deviations concern reporting and disclosure issues as in the cases of Standard 2 on accounting for pensions, and Standard 7 on disclosure of pension obligations and pension funds, as well as valuation and accrual matters as in the cases of deviation from the accounting Standard 11 on accounting for property plant and equipment and Standard 13 concerning leases. The above mentioned Standards are all standards where the compliance are remarkably low (Ibid.)

In Table 1 we report the deviations from accounting standards for each of the 16 municipalities under these categories:

- Number of deviations according to the chief accountant (data from Falkman, 2004; Falkman and Tagesson, 2005)
- Deviation reported by municipality in accordance with the Municipal Accounting Act.
- Total number of deviations according to survey (data from Falkman, 2004; Falkman and Tagesson, 2005)
- Number of deviations according to the professional auditor with reference to the accounting standards of the Council for Municipal Accounting
- Remarks from the professional auditor about deviation but without any reference to the standards of the Council for Municipal Accounting

Insert Table 1 about here

According to Falkman (2004) and Falkman and Tagesson (2005), the 16 municipalities in our study deviated from 91 out of the 224 (16×14) accounting standards issued by the Council for Municipal Accounting. The chief accountants were aware of 59 of those deviations, but only in one case had a municipality reported a deviation in the financial statements. The professional auditors in their inspection reports had reported on 12 deviations with reference to the standards issued by the Council and in another 14 cases remarked on deviations which can be related to the accounting standards issued by the Council. Hence, the auditee seemed to be more aware of the accounting standards than the auditors who were supposed to scrutinize the accounting of the auditees!

In 10 cases the municipalities stated in their financial statements that they complied with the Municipal Accounting Act. In 8 cases the municipalities stated that they complied

with the standards issued by the Council for Municipal Accounting, and 7 municipalities also stated that they complied with generally accepted accounting principles.

In their inspection reports the auditors in 15 out of 16 cases stated that the financial statements gave a true and fair view. In 6 cases they claimed that the accounting was done in accordance with the Municipal Accounting Act – which demands that deviations from accounting standards issued by the Council for Municipal Accounting should be reported with a statement of reasons for the deviation in the financial statements. In the inspection reports 12 of the auditors stated that the municipality in all essential matters complied with GAAP. In Case 7 – a municipality that deviated from 8 out of 14 accounting standards – the auditors even stated that the municipality “...in a praiseworthy way observes GAAP”.

When reading the inspection reports we also noted that the auditors to a large extent referred to old recommendations issued by the Swedish Federation of Local Authorities, from the time before the municipal accounting legislation. According to the Council for Municipal Accounting, these recommendations were repealed and were no longer valid.

At the round-table discussion the representatives did not question our results or even the picture it gave of the audit in the Swedish municipal sector. The representatives from the audit firms even admitted that the results were embarrassing and called for a reprimand, educational update and explicit audit manuals before next year’s audit. About half of the political auditors present at the meeting were upset and indicated that the audit firms did not do what they were paid for, while the other half expressed a more forgiving attitude since “...accounting was not that important”.

One possible explanation for our results, as indicated in both the round-table discussion and in the other interviews, was that the focus during the last few years had been on value-for-money audit rather than audit of accounts.

However, audit focus and competence are not the only explanation. One of our respondents in the interviews pointed to another problem: “... you cannot be too strict and nitpicking, or you will lose the assignment”.

Conclusions

The institutional arrangements of the audit of Swedish municipalities do not seem to facilitate and support the implementation and institutionalisation of accounting standards issued by the standard-setting body – the Council for Municipal Accounting (e.g., Cassel, 2000). In contrast to the private sector (Jönsson, 1985 and Touron, 2005) Swedish professional auditors seemed to obstruct rather than facilitate the implementation of new accounting standards. The results

from our documentary study demonstrate that the auditees are more aware of the new accounting standards than the auditors. The inspection reports from the professional auditors indicate the auditors show reluctance to change (e.g., Mellemvik and Olson, 1996; Tolbert and Zucker, 1996; Seo and Creed, 2002) and are not up-to-date with the new accounting standards issued by the Council. Hence, the professional auditors do not seem to put either normative or coercive pressure on the auditees (e.g. DiMaggio and Powell, 1983).

Our results indicate deficiency in both competence and independence among the professional auditors. Besides the low interest in accounting and auditing among the municipalities' stakeholders (Zimmerman, 1977; Bouckaert and Dooren, 2003), one possible explanation of these results is the indistinct and unclear regulation of the professional auditors' competence and obligations (cf. Cassel, 2000).

In sum, the institutional arrangements do not seem to ensure that auditors and auditing facilitate and support the implementation and institutionalisation of accounting standards and GAAP within the municipal sector in Sweden. The results indicate deficiency in both competence and independence among the professional auditors.

Thus, it can be questioned whether the role, obligation and competence of the professional auditors are sufficiently distinct and explicit in practice as well as in legislation? Do we need new forms for assigning and supervision of the auditors in the Swedish municipal sector –for professional as well as political auditors?

This study indicate that with inadequate institutional and formal settings, the auditors and the auditing firms seem to ally themselves with the auditees in the fabrication of municipal financial reports. According to Goffman (1974:84) "...the use of something already meaningful of primary frameworks" is important in the engineering of a fabrication. The auditors are important actors in this fabrication, since professional audit is an important part of the model or framework that the fabrication is based upon (ibid.).

The ceremonial audit ritual, indicated in this study, may with prevailing institutional settings be sufficient to give a sense of "comfort" to the public (c.f. Pentland, 1993) and the risk may be low for the auditor and the auditing firms due to the low interest in accounting and auditing among the municipalities' stakeholders (Zimmerman, 1977; Bouckaert and Dooren, 2003). Even if the risk is low, the stakes might be high for the auditors and the auditor firms. But today we can only speculate on what will happen with the auditors and the auditing firms if this fabrication, indicated in this study, will be unmasked to the general public and/or Central government or some other stakeholder will increase institutional pressure on the auditors and the auditees.

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Figure 1. The interplay between regulation, supervision and practice

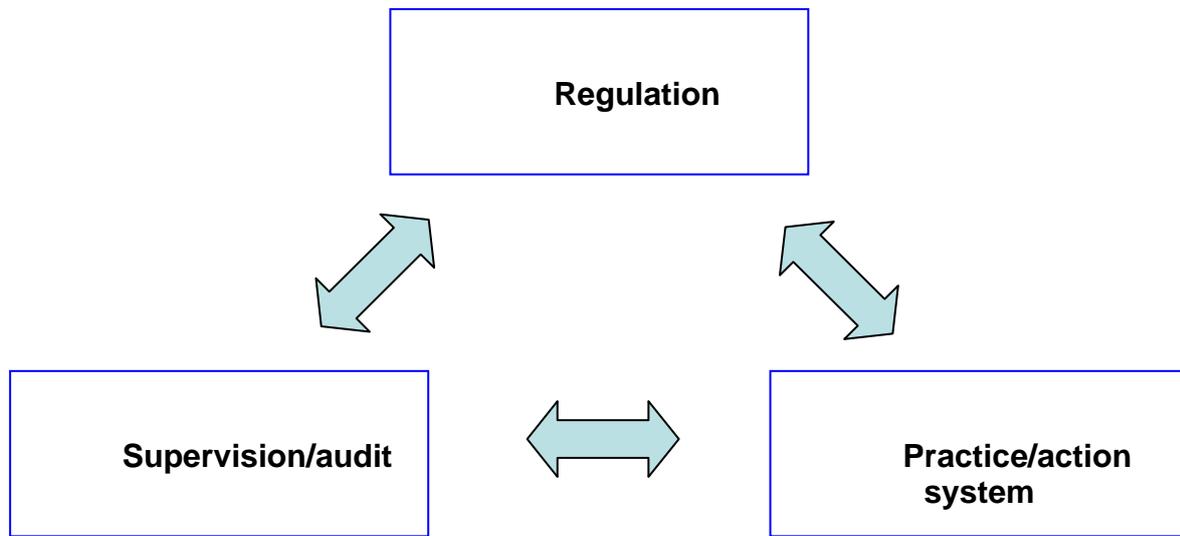


Table 1 Deviation from accounting standards issued by the Council for Municipal Accounting

	Case 1	Case 2	Case 3	Case 4	Case 5	Case 6	Case 7	Case 8	Case 9	Case 10	Case 11	Case 12	Case 13	Case 14	Case 15	Case 16	Total
Number of deviations according to the chief accountant	3	8	3	2	4	2	4	2	4	4	6	4	4	2	5	2	59
Reported deviation	0	0	0	0	0	0	0	0	0	1	0	0	0	0	0	0	1
Total number of deviations according to the survey	4	10	6	3	5	3	8	3	4	6	7	7	7	6	7	5	91
Auditor firm	KPMG	KPMG	KPMG	KPMG	E & Y	E & Y	PWC	PWC	PWC	PWC	PWC	PWC	PWC	PWC	PWC	Own audit office	
Number of remarked deviations with reference to accounting standards	0	0	0	0	0	1	1	2	1	0	4	0	0	0	1	2	12
Number of remarked deviations with no reference to accounting standards	2	2	1	1	2	2	1	1	0	1	1	0	0	0	0	0	14