

# How UK local authorities control their subsidiaries: A conundrum in corporate and public governance

Simbarashe Muzarurwi, Donald Nordberg, Hany Elbardan<sup>1</sup>

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**Abstract:** The pursuit of greater efficiency in a time of austerity in the past decade has led UK local governments to deliver local services in a new way: using subsidiary companies, many of them taking the form of conventional, non-profit enterprises, rather than outsourcing to private enterprises. The practice has energised service innovation by motivating these new corporate managers to act in entrepreneurial ways alien to the ethos of the civil servants whose work they superseded. It is called “corporatisation”, rather than “privatisation”. However, the rapid spread of the practice has outpaced both our theoretical appreciation of the issues and raised a series of practical concerns about the potential for conflicts of interest and the loss of control. This paper examines the small but growing literature about this phenomenon. Using a combination of theories from corporate governance and ethics, as well as documents from the public policy arena, it develops an agenda for research that will explore the varieties of approach to both the value creation and the governance of this new development.

**Keywords:** Local government service delivery, public governance, subsidiary companies, new public management, corporatization

## 1. Introduction

The pursuit of greater efficiency in a time of austerity in the past decade has led UK local governments to deliver local services in a new way: using subsidiary companies, many of them taking the form of conventional, non-profit enterprises, rather than outsourcing to private enterprises. Drawing on a term developed in the literature of state-level enterprise (Grønnegård Christensen & Pallesen 2002; Smith & Walshe 2004), Ferry et al. (2018) call this new development “corporatization”.

Although, the creation of such companies dates as far back as the Victorian era (Skelcher 2017), this is now a growing phenomenon across the whole of the English local government. The trend gained momentum under powers for setting up local authority trading companies introduced in the Local Government Act 2003 and the Localism Act 2011, seeking better governance, as well as improved performance and efficiency of local public services. Ferry et al. (2018) compared annual statements of councils from the fiscal years 2010/11 with those of 2016/17 and found a 50% rise in the number of such entities; most of the growth came in

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<sup>1</sup> Simbarashe Muzarurwi is a PhD student at Bournemouth University and a senior local government officer in the southwest of England. Donald Nordberg is Associate Professor of Corporate Governance and Hany Elbardan is Senior Lecturer in Accounting at Bournemouth University.

the legal form of companies limited by shares, that is, the conventional form of for-profit companies in the private sector. Consistent with this development, local authorities are creating new governance arrangements that establish reporting, accountability and control mechanisms to manage the tension between the need for stewardship and oversight and the companies' need to innovate, take risks and be competitive (Grant Thornton 2014).

These developments seem largely ad hoc, however, a combination of experimentation and just copying each other's practices, what theoreticians might term mimetic isomorphism in a not-yet-institutionalised field. And these governance arrangements can be fraught with ambiguity, controversy and problems (Weaver 2015) and the new commercial entities bring different and potentially conflicting governance requirements from the system which governs local government (Hann 2017). This suggests that the setting up of a trading company creates an entity which will have separate and possibly different interests to those of the council, and it may be difficult to maintain accountability. Deloitte (2013) argue that there is the search for the balance between the degree of control by the parent over its subsidiaries and the degree of independence that needs to be provided to them. In the context of councils there is balance needed between council influence and excessive interference.

The trading companies provide the opportunities for freedom, flexibility and self-financing but have risks as they could make a deficit and the financial, reputational and democratic consequences of service failure will be borne by local government. This understanding is important as these companies have a high initial failure risk due to goal conflict and principal-agent problems (Voorn et al. 2017) and the control arrangements will depend on the form of the company preferred by the local authority. The common options are private company limited by shares or guarantee, joint venture public limited company or community interest company. The other key considerations are the financial and tax implications for both the parent council and the company.

One of the key control mechanisms in local authorities is the maintenance of an internal audit function which is a statutory requirement. In this regard, each local authority is required to undertake an effective internal audit to evaluate the effectiveness of its arrangements for managing risk, control and governance. KPMG (2016) argues that internal audit in local government "is a cornerstone of good governance and is seen as increasing accountability, propriety and higher standards". In the context of council companies, internal audit would be expected to provide assurance that the companies are effectively managed, financially secure and produce the required dividends and that the council's reputation is protected from damage through inappropriate behaviours or methods. The Council as Shareholder will also need reassurance that the entities are operating in an ethically sound manner that is appropriate to their ownership and control by a public body.

This paper gives an overview of local government service control and provides a structured literature review of how councils control their trading companies. It is motivated by the growing number of local authority trading companies, the complexity of governance structures to achieve the right balance between stewardship and oversight and the companies need to innovate, take risks and be competitive as well as the limited prior empirical research in the area. In their brief survey of the field, Ferry et al. (2018: 478) note: "The development of local authority trading companies in the wake of austerity has not been

subject to great scrutiny in the academic literature.” This paper contributes to the limited literature on local authority trading companies and identifies potential areas of future research.

The remainder of the paper is structured as follows. Section 2 outlines and justifies the use of the structured literature review methodology. Section 3 analyses the articles reviewed and provides critique of the literature. Section 4 concludes with suggestions for future research.

## **2. Methodology**

This paper adopted the structured literature review methodology which has also been used in recent accounting literature research (e.g. Kotb et al. 2017; Dumay et al. 2016; Cuzzo et al. 2017). A structured literature review is defined by Massaro et al. (2016) as “a method of studying a corpus of scholarly literature to develop insights, critical reflections, future research paths and research questions. It offers an alternative approach that can either confirm one’s knowledge or open up new avenues for research to which traditional approach may not provide access”. Given the limitations in prior research this methodology was viewed as the one that will enable conclusions on current research position as well as identify research gaps that can inform future research.

### **2.1 Literature review protocol**

Firstly, it was identified that to date there has been discussion of the issues in non-academic papers on local authority trading companies (e.g. Grant Thornton 2014 and 2015; Parliament 2016). Although these papers confirmed the growing number of local authority trading companies and discussed some of the mechanisms being put in place to control the companies such as board structures there has not been a comprehensive look at how these companies are controlled in practice and the role of internal audit is not covered at all. Having identified this research gap, this project was based on undertaking a structured review that captured the history of the subject, the current position, prior research and identification of emerging themes.

### **2.2 Research question**

According to Massaro et al. (2016) “a literature review needs to critique an existing field of knowledge before it can offer a path towards future research by empirically developing research questions”. Consistent with this, this paper set out the following three research questions:

- How is research in the control of local authority subsidiaries in the UK developing?
- What is the focus and critique of the literature on the governance of local authority subsidiaries?
- What are the gaps in research?

### **2.3 Literature search**

This section sets out steps taken to select the dataset for this review. It was clear from the beginning that there was little literature and limited prior research in the area relating to local

authority subsidiaries as a result this paper adopted the keyword search approach. This approach enables the researcher to find relevant articles that extend existing topics in a particular field (Massaro et al. 2016). Given that there are many words that are used interchangeably such as local authority, local government, council, municipality and city, due care was taken in developing a list of the keywords. It was identified that the key words that could be associated with control in a company in the context of this paper were internal audit, audit, governance, internal control and corporatization. As a result, several keyword combinations involving words from the first and second lists were used to maximise the chance of picking any article that is related to the subject matter.

The next step was to identify the databases where the search will be undertaken. As the area is under researched and to widen the search, Scopus and Google Scholar were used as well as the following auditing journals: *Accounting, Auditing and Accountability Journal*, *Auditing: A Journal of Practice and Theory*, *Journal of Accounting, Auditing and Finance*, *Journal of International Accounting, Auditing and Taxation*, *Current Issues in Auditing*, *International Journal of Accounting Auditing and Performance Evaluation (IJAPE)*, *International Journal of Auditing*, *Managerial Auditing Journal* and *African Journal of Accounting Auditing and Finance (AJAAF)*

The titles, abstracts and keywords from all the retrieved articles were examined to ensure relevance. A total of 67 articles were found to be somehow related to the area under review. All the 67 articles were fully reviewed, and the emerging issues points were captured in an excel spreadsheet.

## **2.4 Analytical framework**

This paper adopted the analytical framework that was used by Kotb et al. (2017, but removing journal identity, authorship and jurisdiction as these elements were not relevant this literature review.

## **2.5 Year of Publication**

All articles were categorised into three publication periods that is prior to 2000, 2000 to 2009 and 2010. The majority of the articles 47 which equates to 70% of all the articles reviewed were written from 2010 onwards. This could be explained by the general increase in the interest in corporate governance and indeed internal audit in the aftermath of the global financial crisis. The impact of austerity and the need to adapt to the new government policies could also be cited as the reason for more articles in the post 2010 period. The period between 2000 and 2009 has 15 articles (22%) and this could be attributed to the increased scrutiny of organisations following the financial collapse of organisations at the start of the 21<sup>st</sup> century. The interest in how local authorities and municipalities are governed may have also been influenced by the introduction of New Public Management by different countries.

# **3 Literature Review – Insights and Critique**

## **3.1 Context**

New Public Management (NPM) was introduced in the 1980s in an effort to adopt a transformed and entrepreneurial model of public management by making the public service more business-like and operating along the private sector management models entails. This saw public sector organisations adopting private culture and principles so they could be more efficient, customer-driven and cost effective. One of the main features of NPM is structural disaggregation of supposedly monolithic public organisation into smaller and more autonomous entities (Moldeneas and Torsteinsen 2017). In the UK, NPM emerged when Margret Thatcher was Prime Minister and she introduced amongst others the decentralisation of financial management, conversion of government departments into autonomous, audits, use of contracts, competition and internal markets and extended public-private partnership and privatisation. “Competition results in improved outcomes such as greater efficiency, higher quality of service, a clearer focus on customers and better value for money” (Brown et al. 2000).

A strategy that fits typically in the NPM realm is local corporatization (Voorn et al. 2018). “Corporatization refers to the process by which functions currently operating within a government bureaucracy are reconstituted as entities wholly or partly owned by the government and operating in a commercial environment” Skelcher (2017). It offers benefits such as enabling the local authority to overcome its ability to undertake trading activities thereby generating new income, offering flexibility in employment and reward systems and bringing tax advantages and access to sources of charitable income if companies are registered as charities Ferry et al. (2018). Corporatization represents a significant change in local government and has important implications for the development of the public governance system (Olsen et al. 2017) and it may take different forms and the models of controls that are employed vary considerably (Ferry et al. 2018).

NPM advocated for decentralised control of resources and wanted the market conditions to dictate how public services are delivered thereby ensuring value for money through competition. However, the use of trading companies may be seen as the direct opposite of NPM in that wholly owned companies may not be subject to competitive tendering. The privatisation of public assets in NPM meant that the government lost control on the cost of service delivery as this was now in the hands of private companies yet with wholly owned companies, local authorities retain control and has the ability to influence the pricing strategy as work may be directly awarded to the company without tendering. In addition, privatisation ensures that public services are contracted out and outsourced which encourages competitive tendering for better quality public services. However, in establishing trading companies, insourcing could be experienced in that previously outsourced services may be brought inhouse and managed through the in-house company.

### **3.2 Research themes**

The research themes were classified as internal audit, local government companies, corporatization, governance and audit committee. Any themes that did not fall into any of these five categories were classified as others.

As reflected in Appendix 1 above there is no theme that is the most common although the one with the highest number of articles at 19 (28%) is internal audit (e.g., Thomasson, 2017;

Gamayuni, 2018; Pilcher, 2014). This is followed by the others category (e.g., Taylor & Ciechański, 2010; Ahrens et al. 2018; Kraftová & Kašparová, 2017) with 13 articles (19%) which actually reflects the different research area for local government. Next is local government companies with 12 articles (Moldenæs & Torsteinsen, 2017; Voorn et al. 2017; Tavares, 2017) which equates to 18%. Both corporatization (e.g. Ferry et a., 2017; Grossi & Reichard, 2008) and governance (e.g. Aars & Ringkjøb, 2011; Masegare & Ngoepe, 2018) have 7 articles each and audit committee (e.g. Davies, 2009; Jones & Beattie, 2015) has six.

These findings confirm that in general internal audit is an area that is often researched although not in the context of UK local government. The use of local government companies across the world is common hence it is a subject of commentary in research papers. Corporatization of local authorities is an emerging research area particularly in the UK although there is evidence of research in municipal companies in Continental Europe. However, the low numbers for audit committee and governance are surprising given their importance in the governance of local authorities and associated companies. This view is supported by Montondon (1995) who argues that the demonstration of higher levels of accountability over public funds can be achieved through the effective use of internal monitoring mechanisms such as internal audit and audit committee.

### **3.3 Motivational events**

In most of the cases it was not clear what the motivation for the research was so the majority of the articles 57 (85%) were classified as general whilst 4 (6%) related to New Public Management (e.g., Cristofoli & Longo, 2008; del Rocio Moreno-Enguix et al., 2017). This is surprising as New Public Management is often cited as one of initiatives that changed the way public services are delivered. Austerity has three articles (e.g. Ferry et at., 2018; Ahrens et al., 2018) and this is also very low given the emergence of corporatization in local government in the UK. Seeing that most of the articles were from 2010 onwards it can be argued that, although not expressly stated more authors may have been motivated by either austerity or the global financial crisis as they were some of key events that affected governance of organisations during the period. In addition, corporatization of local authorities in the UK is also often cited as a direct response to austerity.

### **3.4 Institutional Affiliation**

Analysing the institutional affiliation of authors of the articles reviewed helps us to understand the geographical area of the institutions that had an interest in the subject under review. In this paper Continental Europe with 28 articles (45%) is by far the region with more authors affiliated to institutions in that region. This reflects the sizeable number of research papers in municipal corporations in Continental Europe (e.g. Albinsson & Arnesson, 2018; Kanda et al., 2016; Moldenæs & Torsteinsen 2017). Both Australasia and UK have 13 articles (19%) each which reflects a moderate number of institutions in those regions that are covering this area. North America has 10 articles (19%) and Africa has only three papers. The low level of numbers from Africa may suggest that the use of local government companies is still limited and does not attract interest from academic researchers.

### **3.5 Regional focus**

According to Kotb et al., (2017), “analysing the regional focus is important because it us to understand the more-investigated geographical locations and to identify the other regions that might require more attention as fruitful avenues of enquiry.” This paper followed the Kotb et al., (2017) regional classification criterion, removing other and replacing that with Africa to reflect all the key regions as well as adding international to accommodate researches covering more than geographical area.

Continental Europe had the highest number of articles representing 40% of the articles followed by the UK in second with 40% of the articles (e.g., Gold, 1994; Bowerman & Hawksworth, 1999; Jones & Comfort, 2018; Hegazy & Stafford, 2016) Australasia is third with 15% whilst North America is fourth with 12% and Africa has 9% and there are only two international articles (Visnjic et al., 2016; Tavares, 2017). This analysis is consistent with the results in the institutional affiliation analysis and as discussed above there has been a number of empirical researches in Continental Europe in relation to municipal companies.

### **3.6 Organisational focus**

The organisational focus criterion consisted of four classifications: local government, public sector and all sectors. Any organisations falling outside these categories were classified as other.

The results show that the most commonly researched organisation is local government with 58 articles which equates to 86% of the total articles reviewed. Of the 58 articles, 23 of those were specific to municipalities, one related to cities and the rest were for general local government. This was largely expected given that the key search word lists included all words that are used interchangeably with local government. The public sector organisation had six articles (e.g., Da Cruz & Marques, 2012; Zamzulaila et al., 2007; Brown et al., 2000) and only two articles related to all sectors (Colli et al., 2016; Gevurtz, 2004). There was only one article which covered education and was classified as other (Farrell, 2005). Despite a large number of articles focussing on local government, none of them directly addressed how the local authorities in the UK control their subsidiaries.

### **3.7 Research methods**

The research methods criterion was adopted from Kotb et al. (2017) consisted of five attributes: surveys / questionnaires, case study / interviews, archival / content / historical, theoretical / literature review. Any researches that combined two or more these attributes were classified as mixed.

The results of the analysis show that the survey / questionnaire with 19 articles (e.g. Gamayuni, 2018; Badara & Saidin, 2014; Aikins, 2012; Crawford et al., 2008; Fitzgerald & Giroux, 2014) that equates to 28% was used marginally more than the other methods. The other three methods (i) case study / interviews (e.g. Olsen et al., 2017; Garcia-Zamor & Noll, 2009; Citroni et al., 2013) (ii) archival / content / historical (e.g., Argento et al., 2010; Jones & Comfort, 2018; Grossi & Reichard, 2008) and (iii) and mixed category (e.g., Davies, 2009; Albinsson & Arnesson, 2018; Moldenæs & Torsteinsen, had 14 articles (20%) each. The theoretical / literature review method was the least used with only 6 articles (e.g., Gold, 1994;

Tavares, 2017; Masegare & Ngoepe, 2018). Although the survey/ questionnaire had a marginally higher number of articles, it can be argued that all the research methods except the literature review are preferred by the researchers depending on the subject matter. This is particularly so in this paper due the different number of units of analysis.

### **3.8 Nature of research**

The criterion used had five attributes (i) empirical, (ii) conceptual, (iii) exploratory, (iv) theoretical, and (v) other, a category that catered for any articles that did not fit into the other attributes. The empirical category had the majority with 90% of the articles (60) (e.g., Gamayuni, 2018; Usang and Salim, 2016; Badara & Saidin 2014; Davies, 2009; Bowerman & Hawksworth 1999). The theoretical attribute had 4 articles (e.g., Gold, 1994; Tavares, 2017) whilst conceptual (Colli et al., 2016), exploratory (Jones & Comfort, 2018) and other (Cristofoli & Longo, 2008) had one article each. This analysis supports the argument by Kotb et al., (2017) that researchers are preferring the empirical research methods to examine what is occurring in the real life than describing what should be done through the conceptual method

### **3.9 Data analysis**

Consistent with the Kotb et al. (2017) classification, the data analysis categories were (i) quantitative (ii) qualitative and (iii) mixed. The most commonly used method with 40 articles (e.g., Davies, 2009; Ferry et al., 2018; Skelcher, 2017; Moldenæs & Torsteinsen, 2017) was qualitative whilst quantitative had 20 articles (e.g., Gamayuni, 2018; Aikins, 2012; Zamzulaila et al., 2007) and the mixed method had 6 papers (e.g. Pilcher, 2014; Ahrens et al., 2018; Purcell et al., 2014. This is not surprising as this reflects the even distribution of the research methods above.

### **3.10 Literature focus**

The literature focus was classified into seven attributes: (i) internal audit, (ii) governance, (iii) local government companies, (iv) audit committee, (v) corporatization, (vi) multiple incorporating two or more the other attributes, and (vii) other for anything that could not fit into the other categories. The literature focus helps us to understand the main issues under research in the area of interest.

The most common attribute was internal audit with 17 articles (e.g. Thomasson, 2017; Gamayuni, 2018; Pilcher, 2014; Zamzulaila et al., 2007). However, these articles looked at different aspects of internal audit and there were none that specifically considered the role or effectiveness of internal audit in local authority companies although (Mbewu & Barac, 2017; Ahmad et al., 2009; Md. Ali et al., 2010) researched internal audit effectiveness in the public sector and local government. Corporatization had the lowest number of articles (five) (e.g., Skelcher, 2017; Brown et al., 2000). The low level of corporatization articles can be explained by observations made by Ferry et al. (2018) who argue that “there has been little consideration of the medium and long term implications for local authority governance, management, performance and democracy” and this is collaborated by Voorn et al. (2018) who goes further and note that “governance of local corporations is still somewhat of an

enigma for academics and practitioners". Given the increasing reliance on trading companies by local authorities any research in the area will enrich the limited literature currently available.

Whilst there has been empirical research on municipal corporations in Continental Europe especially Italy, Sweden, German and Portugal there is very little academic literature on local authority subsidiaries in the UK. A recent research by Ferry et al. (2018) confirms the increasing number of local authority companies and explains the different legal forms these companies are taking. The same authors also argue that corporatization has not been scrutinised in the academic literature. In addition, Whilst the literature review has established that the three key components of corporate governance: internal audit, external audit and audit committee have been subject to some research in local government, but this did not extend to the local authority companies and there is evidence that there is very little academic literature on local authority trading companies in the UK. There is also insufficient research activity in the UK in relation to internal audit in local government in general.

#### **4 Conclusion**

The structured literature review has established that the use of local authority companies is a growing phenomenon in the English local government and is becoming a key part of public service delivery system. The creation of the commercial entities brings significant benefits, but they also bring significant risks to the councils. Whilst the local authority trading companies are separate legal entities with their own governance structures and free to operate commercially, the relevant local authority remains accountable for the effective delivery of public services and as Shareholder the local authority will be exposed to both financial and reputational risks in the event of company failure. As these trading companies remain under the control of the relevant local authorities, control will be less direct, due to authorities not retaining day-today control over them so there is a challenge on the democratic accountability on service delivery (Parliament 2016). Given the trading companies' freedom to operate commercially to generate profits for the local authority as Shareholder the companies may have separate and possibly different interests to those of the council, and it may be difficult to maintain accountability. Aars et al. (2011) argue that "the establishment of local government enterprises potentially creates a grey area in which steering and, eventually, accountability becomes a muddled issue". In pursuit of growth and profits the trading companies may take too much risk and aggressively adopt private sector principles at the expense of non-financial outcomes which may be a key consideration for the local authority. The local authorities will thus need to ensure that they have the right governance arrangements as accountability and transparency are crucial in protecting democratic values and upholding trust in politically governed organisation (Thommason 2018). The question of accountability is important and as argued by Purcell et al. (2014) there are societal expectations that local government is fully accountable". In view of this there are several opportunities for future research around:

- How are local authorities modifying their governance arrangements to effectively control their subsidiaries?
- How effective are the control mechanisms in place for managing local authority subsidiaries?

- How successful have been local authority trading companies in helping local authorities to deliver better outcomes for residents?
- How are local authorities managing the tension between commercialisation and democratic control?

The success of the companies will depend on how the companies perform commercially as well as the local authority's ability to put in place appropriate control mechanisms. A strong internal control environment in local government offers multiple benefits that include less opportunity for fraud, increased compliance and the likelihood of more efficient resource utilisation leading to service improvements (del Rocio Moreno-Enguix et al., 2017). One of the key control mechanisms that local authorities have at their disposal is internal audit which is as a key component of corporate governance. In the UK, internal audit is a statutory requirement and its role is to ensure that local authorities have adequate and reliable financial management and internal control systems Bowerman and Hawksworth (1999). However, as argued by Pilcher (2014) there has been very little written in the academic journals about the role of internal or external auditors in local government and as reflected in the literature search nothing was found in relation to internal audit practices in local authority subsidiaries. Hegazy and Stafford (2016) concur by stating that "there is a lack of empirical studies of public sector governance and mechanisms in comparison to the extensive private sector corporate governance". The research on internal audit, its contribution and effectiveness in local authority companies will enrich the limited academic literature on local authority companies. Given the importance of internal audit in the governance of organisations there are opportunities for future research on the following:

- How effective are internal auditors in local authority trading companies?
- Serving two masters: How do internal auditors for local authority trading companies manage the conflict that arise from their employment with the councils as Shareholders?
- How do the local authority trading companies' governance impact on internal audit independence and objectivity?
- How does internal audit influence the effective governance of local authority trading companies?

A Parliament Briefing in 2016 on Local government alternative models of delivery identifies a potential problem due to local authorities' ability to set up companies to provide services that are also provided by local businesses. This can generate accusations of 'unfair competition' from local businesses as local authorities can also directly award jobs to their companies without tendering. This then raises the question around whether value for money is achieved in relation to those services directly awarded to the trading company without market testing. Linked to this are some governance issues around how the local authority trading companies conduct business amongst themselves and the barrier protocols that exist to manage any potential conflicts of interest. The conflict of interest problem goes beyond inter-company trading to include potential conflicts for both councillors and local authority senior management. Argento et al. (2010) agree and argue that in relation to local government companies, the local authority is at the same time purchaser, local regulator and shareholder, which may cause conflicts of interest. Grant Thornton (2015) identifies how directors of trading companies who are also employees of the council should manage their conflict of

interest as one of the areas of contention between the councils and companies. Given the importance of transparency and accountability in local government, future research questions could include:

- Do local authority trading companies deliver value for money?
- What has been the impact of local authority trading companies on local businesses?
- How do local authorities manage the conflict of interest relating to local authority trading companies?
- How effective are business models used to manage local authority trading companies?

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