

Local Government Auditing in Germany

Geißler, René

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Chapter 8 – Local Government Auditing in Germany, p 73-82

René Geissler¹, Technical University of Applied Sciences, Wildau

Abstract

Auditing is a traditional function in the German system of local public finance. Its basic mission is to control local finances for accuracy, to avoid misuse of public resources and to support local councils. The priority of auditing is the annual financial statement and accounting, still. Performance is of limited relevance. Given the federal setting of 13 territorial states, the system is complex and fragmented. Another German peculiarity is a parallel structure of financial supervision executed by different public bodies having a particular focus on balanced budget and debt. Local auditing, generally, organises in a two-level structure. The lower level is part of the respective local government, the higher-level part of the state administration. Beyond this basic setting, there are manifold structural options in place lacking transparency and a clear separation of duties. Private involvement in local auditing is very limited. Legislation guarantees independence of auditing with regard to personal independence, autonomy in auditing issues and methods. Local auditing faces several challenges, as local governments do. However, there is no sound discussion on reforms.

Keywords: Public sector auditing; local government; Germany

8.1. Introduction

Auditing local finances is essential to guarantee legality of local procedures and efficiency of local governments, in general. As in every developed country, there is a long history of auditing in Germany. However, its structure and practice is complex, lacks transparency and shows large variance. This observation refers to the specifics of public administration in a federal country, when local finances and auditing are issues for the states and in case of local auditing structures even an issue for local governments. In addition, there is a second pillar of external financial control, which usually gains more public interest. This “financial supervision” builds on different norms and is implemented by different bodies.

1 Professor of Public Management, Technical University of Applied Sciences Wildau, Germany
rene.geissler@th-wildau.de

Nonetheless, there are structures of auditing in all of the 13 territorial states, sharing the guiding idea to control local finances for accuracy and to avoid misuse of public resources. There is no doubt of the necessity for this function, which is meant to support city councils and in a broader meaning local democracy.

Browsing literature for practitioners, as for academia, one finds auditing to be a rather understudied field in Germany. In contrast to other countries, there is no general debate on public failure, no claim of inefficiency and no general mistrust in local governments. One could argue, public administration in Germany benefits from a legalistic tradition having a strong focus on accuracy. Local governments in particular, benefit by large amounts of public goodwill. Therefore, a general public demand for stronger auditing, public scrutiny or political pressure does not exist. However, low level of public and professional discussion contrasts with obvious challenges of local auditing be it within the last decade or the years to come.

As Germany is a federal country showing high fragmentation of local governments, one can assume a large complexity in auditing. Indeed, as this article will show, it is hardly possible to draw a complete picture. Therefore, this article's ambition is twofold: It provides a contemporary overview of basic elements of the German system on the one hand and sketches the large variance on the other. Finally, this article sheds some light on particular challenges of local auditing in Germany, compromising its effectiveness.

8.2. Local Level Framework Conditions

Germany is a federal state, whose local governments are part of 13 territorial states. The local level comprises of about 11,000 municipalities. 103 of them are independent cities, not subordinated to a county and are in charge of a broader set of services. The remaining municipalities are part of one of the 295 counties. Numbers of local governments have been shrinking for decades due to (mostly forced) mergers. Hence, there are three types of local government ('normal' municipalities, independent cities and counties) in every state. Beyond these, we find two further forms of local authority associations in some states, both for reasons of efficiency. In most states, to make up for gaps in their capacity, small municipalities delegate the execution of their functions to so called administrative partnerships). In a few states, counties and independent cities form associations to implement some welfare services. Furthermore, thousands of local enterprises, organised in public or private law, fulfil numerous local functions. Overall, the local level of government is fragmented, has several tiers, in varying number by state, and this impacts on the structure of local audits (Geissler, 2019, p. 103).

When it comes to funding, municipalities and independent cities have the constitutional right to levy their own taxes and set their own tax rates (business tax, property tax) and receive shares of income tax and value added tax. The revenue structure of each municipality links to its economic strength. Counties finance their budgets by contributions from their municipalities and basically have no taxation rights. All German states practice their own system of fiscal equalization and distribute different kinds of state grants.

Local governments are in charge of a wide range of services, mostly devolved by state law. The largest (and growing) share of expenditure is welfare. Further important ones are school infrastructure, roads or utilities. Local governments

implement the majority of public investment. In consequence of federalism and states' responsibility for local affairs, local structure, funding and functions differ between states.

8.3. Structure of Auditing

First, it is necessary to highlight the existence of a dual structure containing fiscal supervision and auditing, which in some European countries is combined in one function (e.g. Poland, England). Secondly, there is a large variance in auditing structures in consequence of federalism.

Fiscal supervision is implemented by multifunctional bodies such as state districts (in charge for independent cities and counties) and counties (in charge for municipalities) (Geissler, 2019, p. 109). Local governments must present their budget drafts for the current year in the previous year. Supervisory bodies focus on the compliance of these budgets with the essential balanced budget rule, fiscal sustainability in general and have to approve new debt. If supervisory bodies assess that the fiscal rules would be violated, they have several sanctions at hand, such as to reject local budgets, neglect loans or enforce cutbacks. For this reason, fiscal supervision is crucial for local governments and a highly political issue. Supervisory bodies usually are state agencies, such as the state Ministry of the Interior, districts or counties on states' behalf.

Comparable systems of fiscal supervision containing elements of ex ante monitoring of budget drafts and credit approvals exist in other European countries e.g. Belgium, France, Netherlands, Austria or Hungary (see Geissler, Hammerschmid, Raffer 2021). Although there are differences in details among German states, this pillar of local budget control is rather transparent and works quite similar referring to structure and instruments. In simple words, state agencies of fiscal supervision check whether financial data meet some thresholds to intervene. The usual thresholds is the balanced budget rule. If this one is violated, intervention starts. Auditing in contrast, checks the accuracy of data without intervention. Cooperation of auditing and supervision is limited in practice. As the auditor lacks any sanction to enforce their findings, they can make use of supervisory bodies. For this reason, audit reports will be transferred regularly to the supervising authority.

In contrast, describing local auditing is challenging due to the variance in even fundamental structural elements. Basically, there is a two-level system of auditing local governments' finance in every state. In simple words, the lower one is implemented by audit offices of local governments itself, and the higher one by external public audit bodies, usually the state audit court. The two-level structure ensures that local governments have an external, more independent and more qualified auditor in addition to the internal one.

The lower level of local auditing (local audit offices) is part of the respective local government, which it is in charge of auditing. They are meant to support the local council in its function of control. However, not every local government runs its own local audit office for reasons of efficiency. The legal obligation to run an own audit office usually varies by type of local government in every state. Mostly, counties and independent cities are obliged to run their own local audit office, because of their budgetary volume and complexity of tasks. Despite this logic, 4 out of 13 states enable larger local governments to choose to function without a local audit office. Therefore, even referring to counties and independent cities the legal situation and audit structure is not coherent across

Germany. Local governments who do not have their own internal audit office, have to mandate a local audit office of another local government to do the work.

When it comes to municipalities as part of a county, the picture gets colourful as six further options exist, in total (Mühlenkamp, 2009, p. 12). Firstly, they can have their own audit offices, so long as it is “necessary” and “proportionally in costs” (5 states). Secondly, local governments can hire their own single auditor to perform the role (4 states). Thirdly, they can use the auditor of another local government (3 states). Fourthly, four states allow them to mandate a private auditor explicitly (4 states). Fifthly, the function of local auditing falls to a local audit committee (3 states). And finally, sixthly, municipalities can take use of the county’s local audit office (3 states). Usually, every of the 13 states offers several options to its municipalities.

Obviously, local audit is a question of efficiency and costs. Most states assume smaller municipalities do not need to have their own local audit office or the resources to manage it. Every state forces all local governments to implement local audits, but none of the states claim every local government must run an own local audit office. The most open legal situation is given in Baden-Württemberg where all structural options apply to all municipalities regardless of size. All further states differentiate by size of local governments.

As local audit offices implement their duties annually, the higher audit court is involved sporadically some years. For example, state law of North Rhine-Westphalia claims external audits shall be executed once in five years (same in Saxony, Hesse, Baden-Württemberg). In most states, the functions of the local and higher audit office overlap to some extent, as the higher one has to audit financial annual statements, too. The particular additional value and function of higher audit offices lie in their independence as they are not part of the respective local administration, their broader experience as they audit all local governments and their comparative method. Again, in consequence of their autonomy states define various structural options for higher audit offices. The most frequent setting is the state audit court (Rechnungshof), which is responsible for audit in 8 out of 13 states. Those state audit courts are in charge of auditing annual financial statements of the state and state administration. Obviously, there are synergies in extending this duty to local governments. In five of those eight states, all local governments are treated in the same way for the purposes of their external audit, irrespective of size or structure. Therefore, state audit offices in these states execute external audits in virtually all local governments. The states of Bavaria, Baden-Württemberg and North Rhine-Westphalia set up particular bodies for external audits of local governments. Those bodies are associations, in which local governments have to be a member and which are funded by member contributions and auditing fees. The state of Lower-Saxony used this organisational model in the period of 2005 to 2010, before transferring this function to the state audit court. In case of the remaining two states Brandenburg and Saarland an ordinary state body implements this function. In general, those structures of external audit offices are rather stable over time.

As referring to local audit offices, the institutional setting of higher audit offices mostly differs by type and size of local government, too. The aforementioned setting is effective for counties, independent cities and larger municipalities. In case of smaller municipalities there are alternatives in six states. In those ones, small municipalities will be audited by the audit offices of their counties.

This setting shows institutional consequences as in six states (Brandenburg, Bavaria, Schleswig-Holstein, Baden-Württemberg, Mecklenburg-Pomerania, Saxony-Anhalt) fiscal supervision and external auditing are combined for the same county administration, although in different units. On the one hand, this might foster cooperation of functions, on the other hand it might increase conflicts of interests, as the county audits its financiers (Person, et al., 2021).

8.4 Scope

With regard to structure, concrete responsibilities of local audit offices vary across states, too. Basically, one can distinguish two core functions, which are to be done in all states, which are not dispensable and which have to be executed by local audit offices. The most fundamental function is the auditing of the annual financial statements with regard to generally accepted accounting principles, legal requirements, proportional financial circumstances, adequateness of all constituent parts as for local government as for its enterprises. A second common core function is the auditing of the exchequer and accounting records. As a basic principle, the choice of particular audits is risk-oriented. Exhaustive audits are not feasible and not mandated by law.

Beyond those two basic functions, state law delegates a range of further ones. Frequent tasks are the audit of electronic data processing (e.g. Hesse, NRW, Rhineland-Palatia). The State of Saxony, as an example, set up an own institution to support this function. Against the background of local budgets, contracting is a field of high relevance and strict regulation. In consequence, North Rhine-Westphalia and Lower-Saxony lists the audit of contracting as a core duty. Auditing the accurate use of state and federal transfers, is another one. Recently, prevention of corruption was delegated to local audit offices in several states. Finally, an unmanageable list of regulation, state orders and standards build a framework of local auditing and make it impossible to present a comprehensive comparison of functions. Historically, the origins of local auditing lie in the examination of the legality of financial transactions. During the last decades, issues like practicality and efficiency of local administration gained growing relevance. Some states mention those, explicitly (e.g. Bavaria, Thuringia, Rhineland-Palatia, Schleswig-Holstein, Mecklenburg-Pomerania).

However, as the local audit office is in charge of auditing annual financial statements and the exchequer, and any administrative issue has financial consequences, it practically can choose its audit focus in the respective local administration. Beyond carrying out legally delegated functions and their own priorities, in some states, the auditor may be mandated to carry out audits by particular local institutions as the city council, committees, the mayor, or the treasurer (e.g. Hesse, Northrhine-Westphalia, Bavaria, Brandenburg, Niedersachsen, Schleswig-Holstein), which have to be implemented. As the scope of local audit is wide and hard to list exclusively, audit finds its limit in political decision making. Any decision, taken by the local council and in line with its responsibilities, has to be accepted and is only the object of audit regarding its financial consequences.

Local auditors' scope, approach and method were subjects of an initiative by the association of local auditors in 2009 (Richter, 2009). This body published new guiding principles meaning to transform local auditing. It claimed to be more relevant to local government leadership, being a driver for organisational change, questioning all audits for their future usefulness, reducing "ex post"

control of accuracy and engaging in “ex ante” control of administrative processes. Although, there are indications for careful changes in this direction, its magnitude in practice remains vague.

As mentioned before, the scope of audit overlaps in between local audit offices and higher audit offices. And likewise, there are core duties and additional ones. Therefore, most higher audit offices are obliged to audit annual financial statements, exchequer, and compliance regarding all fiscal regulation. Most state laws list one additional core function, which is the appropriate use of state grants by the respective local government. Again, higher audit offices may engage themselves in issues of practicality and efficiency.

One might wonder, what the purpose of this somehow duplication of auditing might be. To answer this question, one has to keep in mind the organisational setting of local audit offices, which often are part of the respective administration. An external audit by a higher-level organisation shows a greater autonomy. Unspoken but obvious, there is a kind of external oversight on the quality and procedures of local audit offices itself. In addition, the higher-level audit should have greater experience due to a magnitude of different local governments it is working with and can accomplish some knowledge transfer. One particular advantage of this structure is the ability to execute comparative audits, which means to audit the same functions and issues in several local governments at the same time.

8.5. Auditor Independence

Quality of audit heavily relies on the autonomy of auditors in scope and methods. As auditing is often executed by local governments’ own employees the risk of manipulation by local management and politicians is obvious. All states erected legal walls in their regulation to safeguard auditors’ independence. One can distinguish three playing fields of securing auditors’ independence: (1) Personal protection of auditors against job-related penalties, (2) guarantee of necessary procedures as precondition to audit, and (3) adequate funding for being able to execute functions properly.

Fundamentally, the local audit office has to execute its functions without directions of major or city council. It chooses its foci of audit and its methods through its own best discretion without regard to policies and politicians. The local audit office is meant to support budgetary functions of the city council and its general function to control the administration. In consequence, it is directly responsible to this council, which it reports to. Only this city council can withdraw the head of its local audit office. This is a kind of personal protection against the major, who could otherwise dislocate any auditor he/she is uncomfortable with. In practice, there are ways to interfere by major or council, e.g. by staffing.

Further guarantees of autonomy come with employment status of at least the head of local auditing as public servant and the special status of this unit itself (Fiebig, 2018, p. 90). When it comes to procedures, auditors are free to request any information and documents they need to fulfil their duties. Local government executives have to deliver, otherwise audit would not be feasible. Another aspect of independence is funding. Naturally, quantity, intensity and quality of auditing depends on resources like staffing and budget. State law guarantees an “appropriate funding” but without any doubt this appropriateness is hard to define coherently. Number of staffing, experience, size and complexity of local administration, have to be considered and will end up in different numbers for

similar local governments. Inevitably, there is room to strengthen and weaken local auditing by the way of funding. Apparently, observable staffing does not link to any formal indicators of the respective local government (Zahradnik, 2018, p. 6). This finding confirms study results of fiscal supervision as the second pillar of external control. Staff numbers and budgets, often are kind of accidentally determined or result of historic path-dependences (Person et al., 2021). Staffing and budgeting of local audit offices is an issue of local politics and decided by the city council. Apart from its director, there is no regulation in place.

Nonetheless, there are some possibilities to influence local audit offices in their scope. First, mayor and city council can mandate particular audits. Second, a growing number of fiscal aid programmes by federal level, claims local audit offices to proof accuracy of application. Those devolved audits limit capacities for own considerations and, to some extent, autonomy.

There are no public data and numbers of local audit offices, staff or budgets. One recent survey presented an average staff number of five auditors per local audit office (Zahradnik, 2018), with large differences between states. Referring to relevant aspect of employment as status as public servant, salary level or professional background, there are no public data available, too.

A substantial number of municipalities do not run an own local audit office or do not employ an own auditor, but use other local governments' bodies. In this case, there is no leverage for local majors or councils to affect local audits' independence, as external bodies execute this function. This constellation applies to higher audit offices too, as they are funded by the states or by mandatory fees. Those bodies have one additional advantage in contrast to their local counterparts. It is the power of publicity, as they publish annual reports on local finances and administration.

8.6. Performance Management

Clearly, performance has not been a traditional priority of German public administration and local governments. The idea somehow arrived in the 1990's, when global public management trends transformed into its German adaption labelled "New Steering Model" (Kuhlmann et al., 2008). This movement resulted in the implementation of accrual accounting within local governments, containing the legal duty to practice performance management, which was meant to be a substantial change along with high expectations in managerial practice. However, this reform started in 2005 and evaluations show hardly any implementation of performance management. Having said this, higher audit offices took some stakes in this discussion, being a promotor of reform and trying to foster management.² Although, most states legally dictate local governments to integrate targets and performance indicators in their budget plans and to report publicly about fulfilments hardly any local government follows this duty (Geissler et al., 2021, p. 27). There is little evidence, of local audit offices, higher ones or fiscal supervision to follow up this violation of budgetary rules. One explanation might be the overload of all subjects involved with even more basic parts of accrual accounting. Therefore, performance indicators could not be subject of auditing, yet. Referring to accrual accounting, this fundamental change overburdened local auditors itself, as there is a long backlog of auditing financial statements. Using the example of Saxonian

2 For example, the State Audit of Saxony regularly presented numbers on low implementation and claimed higher efforts.

municipalities, only a small minority of 15% holds the legal term limits (Geissler et al., 2020, p. 20). Another reason of limited attention on performance in local audit offices is the limited size of those offices. Mandatory legal duties cover an overwhelming share of capacities. Performance and efficiency go by the board, in consequence. In theory, the change of accounting principles towards accrual goes hand in hand with particular instruments and indicators, enabling local audit offices to control performance. In reality, those instruments are hardly implemented, yet.

At least on the level of higher audit offices, performance plays some role in legal mandates. Some states, explicitly charged their higher audit offices to performance measures as they implement comparative audits of several local governments based on indicators (e.g. Hesse, NRW). For the case of NRW, a recent study that evaluated the higher audit office confirmed the auditing approach of efficiency, which is assessed as useful by local officials (Bogumil and Ebinger, 2016, p. 122f).

8.7. Regulatory setting

In contrast to other countries such as England, auditing local governments in Germany is almost completely implemented by public officials. It is a public audit regulatory setting. However, there are at least three different options of private involvement. First, all audit offices are free to subcontract private auditors without further approval. One study of local audits suggested about 2% of the money used for auditors funds private sector support for audit (Zahradnik, 2018, p. 4). Second, four states allow a full contracting of local audits. In this case, no local audit office exists, but decisions about particular single audit mandates will be done by the city council. This kind of “full privatisation” brings all well-known challenges and risks for the effectiveness of auditing. Although, there is no data on the use of this option one can assume it is very limited. One particular sample of privatisation exists in the state of Hesse. Referring to higher audit office, the law makes public-private-cooperation the standard mode of auditing. The state audit court tenders all its audits and limits itself to controlling and project management. And thirdly, audits of local public enterprises are legally devolved to private auditors, as local offices were naturally overburdened. Those three modes of private involvement are not recent ones. The regulatory setting of local auditing did not see major adaptations within the last decade.

8.8. Conclusion

Although, there is no intensive or coherent debate about status and future of local auditing, one can highlight some trends in this field. Those trends directly link to changes in local government itself, which obviously impact on the role, scope, methods and identity of local auditing. German local governments have been challenged constantly by external developments since the 1990's. Just to name a few: Formal privatisation of local functions resulted in complex corporations especially with independent cities, the introduction of accrual accounting overburdened local auditors, costly digitalisation, growing influence of federal and European level and state bailout programmes in consequence of financial crisis. As in German local government in general, local audit offices have an older workforce, confronting them with large numbers of experienced staff retiring in the upcoming years and, in consequence, challenges in recruiting. On the other hand, this provides an opportunity for transformation, too (Zahradnik 2018, p. 12). All of those challenges affect local auditing resulting in a higher complexity, additional tasks and rising demands. One natural

consequence of growing complexity is the necessary specialisation of auditors. But, audit offices are faced with the challenge of meeting this necessity against the background of limited staffing and salary levels? One can expect further processes of amalgamation leading to fewer but larger audit offices (Schwartzing, 2019, p. 102). Another option to deal with this challenge is that audit offices would specialise and cooperate more than in the past. Private auditors' role will emerge, too, driven by lacking technical competencies or the lack of staff. As stronger involvement of private auditors was a, somewhat hidden, trend recently, this probably won't end in total privatization of local auditing, as this rivals against the basic understanding of German public administration. The traditional mission of auditing legality of accounting ex post, is more and more questionable. Referring to expert opinions, auditors' scope was drifting from traditional accuracy to efficiency, changing auditors' position from "ex post" to "ex ante" control. Summing up, the world of local government has changed fundamentally in the last two decades. It is questionable, whether the world of local auditing followed those changes; at least, its regulation remained relatively stable. Consequently, there is a growing risk of audit losing relevance in this new world.

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