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A contingency theory perspective on the risk management control system within Birmingham City Council

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ABSTRACT

In recent years the topic of risk management has moved up the agenda of both government and industry, and private sector initiatives to improve risk and internal control systems have been mirrored by similar promptings for change in the public sector. Both regulators and practitioners now view risk management as an integral part of the process of corporate governance, and an aid to the achievement of strategic objectives.

The paper uses case study material on the risk management control system at Birmingham City Council to extend existing theory by developing a contingency theory for the public sector. The case demonstrates that whilst the structure of the control system fits a generic model, the operational details indicate that controls are contingent upon three core variables—central government policies, information and communication technology and organisational size. All three contingent variables are suitable for testing the theory across the broader public sector arena.

1. Introduction

In recent years the topic of risk management has steadily moved up the agenda of both government and industry, to a level where "it is more important than ever before" (Lam, 2006). This development has run parallel with the evolution of regulatory frameworks for corporate governance in response to a series of well-publicised corporate scandals and failures across the world (Collier and Agyei-Ampomah, 2005).

Recent governance reforms, such as the Sarbanes-Oxley Act in the US, the Basel II Capital Accord and the revised Combined Code (2003) in the UK have sought to minimise the risk of future major corporate failures via tighter regulation of internal control systems. In the USA, the crisis of confidence in the capital markets that resulted from a series of control failures led to the SEC calling for companies to improve risk control and compliance systems in the belief that strong control systems would serve to strengthen investor confidence.

National and international governance regulations reflect the view that corporate governance, internal control and risk management are inter-dependent. The boundaries between the concepts may appear rather blurred at times, and it is not always clear whether risk management is a sub-division of internal control or vice versa, but the dominant recurring theme is that risk management is an integral part of the process of corporate governance (McRae and Balthazor, 2000). In a private sector context, the primary responsibility for all three rests with the Board of Directors.

Private sector initiatives to improve risk and internal control systems have been mirrored by similar promptings for change in the public sector, where risk management is also seen as an important dimension of good governance as well as a tool to aid the achievement of strategic objectives. Addressing members of a public sector governance and risk forum, the Australian Auditor General observed that: "as corporate governance receives increasing attention—I have heard it referred to as an '*unrelenting tide*'—it is becoming almost a given that effective risk management, as a

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corner stone of good corporate governance, results in better service delivery, more efficient use of resources, and better project management" (Mc Phee, 2005). The Audit Commission in the UK also sees a direct link between risk management and service delivery in arguing that "an authority's systems of internal control is part of its risk management process and has a key role to play in the management of significant risks to the fulfilment of its business objectives" (Audit Commission, 2001, p. 7).

The underlying arguments driving the development of formal risk management controls therefore appear to have strong similarities across both private and public sectors, but it is simplistic to assume that the resulting systems will be the same. Anecdotal evidence suggests that public sector risk management is distinct and different from private sector risk management, (Fone and Young, 2000; Mc Phee, 2005), but there is a lack of academic literature that tests such views.

This paper uses an exploratory case study of the risk management system within Birmingham City Council to develop a contingency framework for the public sector. The decision to use contingency theory to explain the case study findings was stimulated by the fact that it recognises the influence of organisational context upon choice of control system (Chenhall, 2003), and the public and private sectors are arguably different contexts. Additionally, the paper responds to Chenhall's (2003) recognition of a need for more contingency based research in not for profit organisations.

The contingency approach to management accounting control emerged out of earlier research in the area of organisation theory (see for example the work of Bums and Stalker, 1961; Woodward, 1965; Lawrence and Lorsch, 1967; Pugh and Payne, 1977.) Organisational theorists suggested that the structure and activity of complex organisations was subject to the influence of a number of contextual variables (Waterhouse and Tiessen, 1978) such as technology and environment.

The transfer of this "ready-made theory" (Otley, 1980) to management accounting led to the key contingent influences on management control systems being categorised under the headings of environment, technology, structure and size. Langfield-Smith (1997) provides a useful summary of contingency research, and in common with Otley (1999) and Chenhall (2003) she also notes the emergence of a literature on the role of strategy as a contingent variable.

This paper contributes to both the empirical and theoretical literature within management accounting. Empirically the choice of the risk management system as the focus of the study provides a novel context for the analysis of an emerging issue and shifts the emphasis away from the "narrow financially biased perspective" that "dominates much of the control literature" (Otley et al., 1995). It simultaneously addresses the paucity of studies of control systems in operation (Otley, 1999). In terms of theory, the paper develops both accounting and organisational theory by reformulating contingency theory, using a new set of variables that are specifically suited to the public sector context.

The next section explains the background to the case study via a summary of the evolution of thinking and practice in public sector risk management. This is followed by a brief explanation of the research method, and the case study site. The fourth section details the basic structure of the risk management system in Birmingham City Council, which provides a background for consideration of the specific factors influencing the way the system operates in practice. Information collected for the case is then used to demonstrate that three core variables – central government policies, information and communication technology and organisational size—influence the practical application of the control system. With the exception of organisational size, these variables are new to contingency theory and they provide a framework for a public sector contingency theory that is new to the literature. We conclude that risk control systems within Birmingham City Council are contingent upon the identified variables but that further research is required to test their applicability to other management control systems across a broad range of public sector organisations.

2. Risk management in the public sector

The period 2000–2002 marked the publication of a series of government documents that drew attention to the need for better risk management within the public sector and also contained initial guidance on how to set up a risk management system. Within central government, the risk management agenda was initially driven by the publication of a report by the National Audit Office (NAO, 2000). This was rapidly followed by Treasury guidance (Treasury, 2001) which provided a basic introduction to the concepts of risk management, and is now commonly referred to as the Orange Book. An update of the Orange Book has since been published (Treasury, 2004), and further support and guidance is provided via the Treasury's Risk Support Team as part of "The Risk Programme".

Within local government, risk management forms part of a broader governance framework that was developed jointly by CIPFA (Chartered Institute of Public Finance and Accountancy), SOLACE (Society of Local Authority Chief Executives) and the Local Government Association (CIPFA, 2001). The framework identified risk management and internal control as defining principles of good governance and recommended that each local authority should establish systems for the identification, evaluation and monitoring of risks, and undertake an annual assessment of the risk management and internal control systems.

The same year the Audit Commission published a paper (Audit Commission, 2001) aimed at raising awareness about the need to manage key strategic risks in local government and offering guidance on the development of formalised risk management systems. The paper emphasised the responsibilities of both senior management and elected members in relation to the implementation of a risk management policy, and argued the need to recognise risk as encompassing opportunities as well as threats. Responsibility for providing assurance on the effectiveness of risk management processes and internal controls was placed firmly in the hands of internal audit. The Audit Commission also highlighted how risk management might help in the production and monitoring of the best value performance