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# **Compliance Audit of Anti-Corruption Regulations: A Case Study from Carpatistan Customs**

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Introduction .....	2
The Value of Internal Audit over Other Methods of Assessment .....	3
Background and Methodology for the Anti-Corruption Compliance Audit .....	4
Compliance With Anti-Corruption Regulations.....	6
<i>Ignorantia Juris Non Excusat</i> .....	10
Assessing the Culture of Compliance and the COSO Framework.....	11
Testing for Control Deficiencies (Regulatory Failure).....	14
Fitting Internal Audit into the Broader Debate on Anti-Corruption Regulation .....	17
Conclusion .....	18
Bibliography .....	18

### Abstract

The principles and findings from internal government audits (aimed at generating recommendations to improve compliance with anti-corruption regulations) can greatly contribute to the wider anti-corruption literature. Internal audit techniques can overcome the weaknesses of the four predominant approaches to evaluating anti-corruption regulatory performance – the systems design approach, the *ad-hoc* controls studies approach, the descriptive legal analysis approach and the prescriptive manuals and handbooks approach. This paper discusses a compliance audit of anti-corruption regulations in an anti-corruption audit conducted in 2009. The audit findings and recommendations illustrate the ways that models and previous research in the social sciences can be used in the internal audit methodology in order to generate recommendations which provide risk-adjusted, positive net benefits for the government agency.

**Keywords:** internal audit, corruption, customs, Carpatistan

**JEL Codes:** H83, M42, H26.

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# **Assessing Regulatory Performance through Anti-Corruption Compliance Audit: A Case Study from Carpatistan Customs**

Bryane Michael (University of Hong Kong) and  
Alexey Gubin (Russian Customs Academy)

## **Introduction**

Internal (public sector) audit represents one of the least understood, yet most important tools in the fight against corruption – particularly for a customs service. Most people view auditors (internal auditors included) as eyeglass wearing bean-counters who look for discrepancies in stacks of financial figures. While such an image does reflect the work of the internal auditor (particularly during financial and fraud audits), much audit work involves the application of creativity – as the auditors try to generate recommendations which will generate greater social benefits than costs. Except for Khan (2006) -- as a recent and welcome contribution to the literature -- until now, the anti-corruption literature has failed to address internal audit methodologies as a way of measuring the performance of anti-corruption regulations.<sup>1</sup> This paper seeks to remedy this gap in the literature as well as build a bridge between the audit profession and academic social science discourse. We build this bridge by presenting the results of an internal audit of anti-corruption regulations in the Carpatistan Customs Agency conducted by the Administration's Internal Audit Department in March 2009.<sup>2</sup>

The audit of regulations which help enforce legislation aimed at requiring civil servants to declare their income (and any substantial changes) as well as potential conflicts of interests represents a major element in the fight against corruption. The first part of the paper will provide a very brief overview of the literature on assessing the performance of anti-corruption laws (focusing at the regulatory level rather than the legislative level to the extent possible). The second section provides a simplified view of the audit methodology – as applied to our internal audit -- for the social scientist not versed in the specifics of internal non-financial audit. In that section, we describe the audit methodology generally, the laws and regulations guiding our audit and provide the reasoning for many of the decisions we took in the design of our audit. The third section presents compliance with specific anti-corruption regulations (controls in audit terminology) and recommendations which emerged. The fourth section addresses the way which the audit assessed ignorance of anti-corruption regulations as an explanation for non-compliance. The fifth section describes the way we tackle COSO standards and assess the customs service's culture of compliance. The sixth section describes the way we assess the quality of anti-corruption regulations in the customs service and the rationale behind the recommendations the audit generated to improve the control of corruption-related risks -- using two particular regulatory instruments called the Code of Ethics Regulation and the Regulation on Disciplinary Procedures. The seventh section briefly pontificates about the value of non-financial internal audit techniques and findings for the broader social science literature on anti-corruption (and visa-versa); while the final section concludes.

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<sup>1</sup> Baltaci and Yilmaz (2006) try to tackle the wide-spread lack of understanding of the benefits (or even methods) of internal audit in developing country public sector organisations (while briefly mentioning the ways that internal audit can detect corruption). The reader unversed in internal audit may see their paper for a succinct and useful background.

<sup>2</sup> I refer to Carpatistan to protect the identity of the audited entity. By tradition, I have referred to each country as Carpatistan – and the name does not give any indication of the country's geographical position. Citation of laws and audit standards represents the Harvard citation method's main weakness. Instead of following the convention that organisations should be cited in-text, we cite an abbreviated form of the law or publication title. For audit standards or other guidance, we cite the actual guidance article instead of the page number.

As we promise to build a bridge between the audit profession and academic social science discourse, we provide we provide definitions from the audit field as we go along. Audit possesses its own terms of the trade (jargon). Internal audit professionals will find our treatment of the audit (both in general and in this particular engagement) as unrigorous. Social scientists will probably find our translation of social science terms into audit terminology as unnecessary and possibly condescending. However, we hope increased familiarity with the “nuts and bolts” of non-financial internal audit practices among the broader social sciences will encourage greater dialogue between these two disciplines.

### **The Value of Internal Audit over Other Methods of Assessment**

The literature on the measurement of performance of anti-corruption regulations in government agencies can be grouped into four categories (as shown in Figure 1). The first, and predominant approach, focuses on the way in which audit fits into the larger “anti-corruption system.” These studies, often abstract in nature -- providing flow charts which “show” how audit intersects with other boxes labeled as state institutions -- describe the importance of audit in a broader government policy aimed at fighting corruption. While acknowledging the importance of internal audit in anti-corruption work, these authors rarely demonstrate a detailed knowledge of the actual techniques used by internal (or external) auditors. The second approach – usually taken by authors with a background in political science and often comparative in nature – focuses on the existence or absence of particular programmes in a government agency. Such an approach resembles a controls-based audit. Authors visit state institutions and ask if these institutions implement particular programmes, such as asset declaration schemes. However, such studies tend to provide simplistic comparisons and contrasts of the adoption of these programmes. For example, Larbi (2007) assesses whether four African countries have adopted conflict of interest programmes – using pre-defined programmes and categories.

**Figure 1: The Four Approaches in the Literature to Address the Role of Internal Audit in Fighting Corruption**

<b>Approach and Representative Authors</b>	<b>Description</b>	<b>Weaknesses compared to internal audit reporting</b>
Systems design approach (Kayrak, 2008; Shah, 2007).	Discusses the importance of audit in preventing corruption (usually focusing on the Supreme Audit Institution) and how audit “fits” into a larger anti-corruption framework	Does not provide concrete details about particular audits. Provides little practical guidance for regulators in internal audit departments.
<i>Ad-hoc</i> controls studies approach (de Sousa, 2009; Larbi, 2007)	Assesses corruption risks based on the establishment of controls in an organisation (usually as assessed by interviews and second-hand reports).	‘Controls’ tend to consist of whether particular programmes are implemented (such as complaint hotlines).
Descriptive legal analysis approach (Cain <i>et al.</i> , 2005; Trost and Gash, 2007; Rosenson, 2006; Acar and Emek, 2008).	Often historical in nature, describes legal issues related to the implementation of internal audit programmes aimed at detecting or preventing corruption.	Provides only general and non-operational background; particularly in a developed country context.
Prescriptive manuals and handbooks approach (Nigel and Samociuk, 2007)	Provides text-book approaches to detecting corruption as a variety of fraud.	Too general (and often abstract) to apply in practice. Ignores other aspects of a wider anti-corruption programme in place.

Source: authors

The third approach – descriptive in nature – focuses on the previous attempts particular state agencies have made in the adoption of internal audit practices aimed at detecting corruption. For example, providing an extensive background in the legal founding of audit in the US, Cain *et al.* (2005) discuss the difficulties in implementing internal audits aimed at detecting corruption in the US. The final approach taken in the literature – often written as guidance manuals -- focuses on prescriptive studies. These studies discuss audit principles and how they apply generally to the detection and/or prevention of corruption. For example, Nigel and Samociuk (2007) provide an excellent overview of the mechanics of a fraud audit. However, any discussion of such an audit ignores the wider anti-corruption programme in place. The internal auditor must know about progressive practices the agency can take which go above and beyond the minimum obligations set in legislation; as well as changes in thinking about anti-corruption theory and practice.<sup>3</sup> Naturally, such an abstract typology provides ideal-types and these approaches often overlap in a particular study. For example, Anechiarico and Goldstock (2007) look at a number of Inspectors General in the private sector, tracing their historical background and developing a table of their common features. They provide a series of recommendations for using these inspectors general in the public sector – particularly when dealing with public procurement.

These four approaches suffer from a number of weaknesses as contributions to the literature on evaluating anti-corruption regulation performance. First, they fail to focus on risk – looking (particularly in the case of *ad-hoc* control studies) – on the implementation of existing programmes. Second, each author may choose a different methodology (whereas as we shall see, the internal audit framework provides for a coherent and comparable basis for studies). Third, studies based on these approaches rarely, if ever, generate recommendations for use beyond the particular study. Findings are either in general terms (related to political theory) or point out specific lack of implementation of particular programmes. The assessment of anti-corruption programme performance, using these methods, requires the comparison of current practice against some normative ideal established in the author’s academic tradition -- instead of in comparison to the agency’s objectives. In other words, these studies – simply put – fail to address the role of compliance with anti-corruption regulations.

## **Background and Methodology for the Anti-Corruption Compliance Audit**

As with any internal audit, the International Standards for the Professional Practice of Internal Audit (ISPPA) guide the anti-corruption compliance audit. Far from being a check-list or rigid set of instructions guiding internal auditors, the Standards provide overarching principles and general steps which guide the internal auditor during an audit. An anti-corruption audit – or engagement – places supreme importance on the identification and minimisation of the risk of losses to the agency (Standards: 2120). In the case of an anti-corruption internal audit for a government body like customs, the focus rests on the potential financial loss or infringement of rights resulting from the use of their public powers for private gain.<sup>4</sup> In Carpatistan, with imports of roughly \$25 billion under the

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<sup>3</sup> Balia *et al.* (2007) provide a good overview of both the need to consider wider institutional factors when evaluating ethics programmes in government organisations as well as critiques of such programmes.

<sup>4</sup> Customs officials possess, in most jurisdictions, a number of discretionary public powers which may result in the bribe-seeking or other corrupt behaviour. Such powers pose a risk to their customs agency. Common powers include the right to search goods and persons, question the valuation or origin of goods being imported into the country, and the right to refuse the clearance of goods until an importer convinces a customs inspector that he or she has completed the customs procedures of that jurisdiction. For a general background on corruption in customs, see MacLinden (2005) or Ferreira *et al.* (2007).

supervision of the Customs Agency, the possibility of corruption in the organisation's operations could lead to enormous damages from civil cases and in terms of revenue loss.

Legislation provides the legal basis for any administration – such as the Carpatistan Customs Agency – to establish anti-corruption procedures, policy and practices (known as controls in audit terminology).<sup>5</sup> In the mid-2000s, the Carpatistan government passed two pieces of legislation which significantly changed the anti-corruption internal audit landscape in Carpatistan. From an audit point of view, the Anti-Corruption Law creates a number of relatively trivial (and difficult to audit) restrictions – preventing Carpatian civil servants from using budgetary funds to finance political activities, acquiring shares in companies in which the public official has regulated or supervised, and accepting large value gifts. A particularly interesting – from an internal audit point of view – new obligation established by the Anti-Corruption Law requires all public officials to declare their property upon taking up state service and to report on significant changes. These two articles – along with a monitoring mechanism – legally establish a system often referred to as an asset declaration programme or scheme.<sup>6</sup>

The Conflict of Interest Law (2007) represents the other major piece of legislation which establishes new (and auditable) obligations on public officials.<sup>7</sup> Some of the more trivial provisions (in terms of risk to the Administration's operations) include the prohibition from hiring relatives (art. 6), the requirement to place ownership or managerial interests into trusteeship (art. 10), and prohibitions from working for a company which the public official supervised or regulated while working for government (art. 17). Articles 7 and 13 contain the major “auditable” obligation – requiring public officials (politicians) to report to the State Commission for the Prevention of Corruption in cases where they suspect a conflict of interest may be present in a decision they take. These articles require public officials to report to their agency such a conflict of interest (if they are non-political level civil servants).<sup>8</sup>

The Carpatian Customs Agency has adopted a series of regulations -- containing over 300 provisions -- aimed at implementing the anti-corruption legislative framework. As required by the Standards, these regulatory provisions – called controls in the audit literature – should be assessed according to the risk to the Customs Agency if non-compliance occurs (Standards: 2120). The audit team considered the potential costs to the Carpatian Customs Administration for non-compliance with these various provisions (Standards: 2130).<sup>9</sup> The team also discussed these risks at length with the client to determine on which controls the audit team would focus their compliance audit (Standards 2200). The audit team agreed with the clients (in this case, the regional customs house heads), the audit coverage, the methods the audit team would use and the type of testing of controls used – an exercising known as scoping (Standards: 2220). Two particular provisions we chose relate to compliance with the Regulation on Disciplinary Procedures

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<sup>5</sup> In theory, any customs service also has commitments to uphold international obligations, such as the World Customs Organisation's Revised Arusha Declaration (2003). In practice, however, the Declaration results in no legally binding obligation and the text of the abstract principles contained in the Declaration makes compliance audit impossible.

<sup>6</sup> See Sherlock (2002) for the discussion of the performance of a similar asset declaration scheme in Indonesia and Messick and Simpson (2006) for a list of countries with such schemes currently in place.

<sup>7</sup> For a review of the issues and legal provisions in a number of OECD member states related to similar schemes, see Bertok (2003).

<sup>8</sup> Cain *et al* (2005) provide a critique of conflict of interest disclosure schemes; while Rosenson (2006) find that the costs of an ethics law can outweigh the benefits.

<sup>9</sup> See Nigel and Samociuk (2006) for more on the quantification of corruption risks in the operations of a public agency.

relating to the asset declaration scheme and the conflict of interest scheme. Non-compliance with these articles would result in fines levied by the Civil Service Agency and civil financial liability for corruption resulting from control failures.<sup>10</sup>

The audit team conducted fieldwork through substantive testing – checking to see if Customs officials followed the controls – in the mid-2000s. Substantive testing consisted of questionnaires given to both managerial-level and employee-level customs officials. Covering about 10% of all Customs staff, 599 surveys (400 surveys of employees and 109 surveys of managerial staff) provided data on compliance practices.<sup>11</sup> As discussed below, a series of questions also tested attitudes related to the overall “culture of compliance” within the Carpatistan Customs Agency. The purpose of internal audit aims to generate recommendations which add value and reduce risks (Standards: 2100). As such, we choose not to look at (called vouching in the audit literature) the claims of each customs official and provided anonymity for all survey responses. In the language of audit, the team sought “control deficiencies” (what a social scientist would refer to as institutional regulations which provide adverse incentives to agents) instead of “control exceptions” (what a social scientist would refer to quite simply as criminal or naughty conduct).

### **Compliance with Anti-Corruption Regulations**

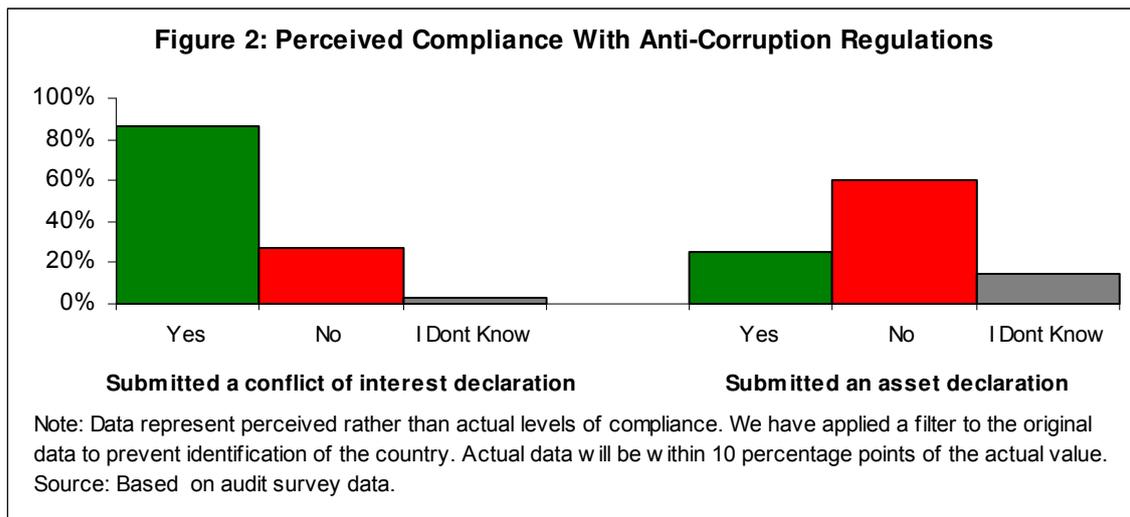
The data show relatively wide-spread anti-corruption control failures. As shown on the left-side of Figure 2, between 20% and 40% of staff claimed not to have filed a conflict of interest declaration.<sup>12</sup> On the other hand, between 75% and 95% of staff claimed to have filled in their statement indicating that they are not currently in a conflict of interest. Even if staff did face a conflict of interest, the law provides for very weak incentives to declare such conflicts. The Conflict of Interest Law stipulates that an investigation of a Customs official for conflict of interest would lead only to forcing him or her to file a conflict of interest declaration. As such, the relatively senior-level regional customs region managers in the (our clients for this engagement) face little liability or regulatory risk from employee non-compliance with the conflict of interest scheme.

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<sup>10</sup> In a customs context, control failures implicitly lead to the risk of violating an individual’s procedural and civil rights. However, as such rights are notoriously difficult to define, the auditor must bear in mind the non-quantitative risks represented by the violation of these rights (Carmona, 2009).

<sup>11</sup> We have scaled our data in the data to prevent identification of the country by the size of its staff, budgets, or value of imports. We have applied a consistent method of scaling to ensure that the relationships in the data remain consist.

<sup>12</sup> As previously noted, these data reflect customs officers’ own admissions of compliance with the anti-corruption regulations in place. As a scope limitation, the Internal Affairs department did not (rightly) allow the audit team to vouch survey respondents’ answers with conflict of interest and asset declarations on file.



The bulk of the risk for non-compliance with the anti-corruption regulations selected in this audit focused on un-filed asset declaration forms. As shown on the right side of Figure 2, between 50% and 70% of employees surveyed indicate that they have not filled in asset declarations. According to the Anti-Corruption Law, failure to fill in an asset declaration can lead to a fine of between €50 and €150. According to the audit team, if these fines are levied (and an average fine of €100 is actually paid) customs staff would (and should) be held liable for negligence. The value of the fines from customs staff would equal €590,000 for the statistical aggregate of Carpatistan we have created from the audit data used from another country. Thus, control failure on the collection of asset declarations – regardless of the actual inspection of these inspections (which is not required by law) – poses a significant risk to the customs staff.

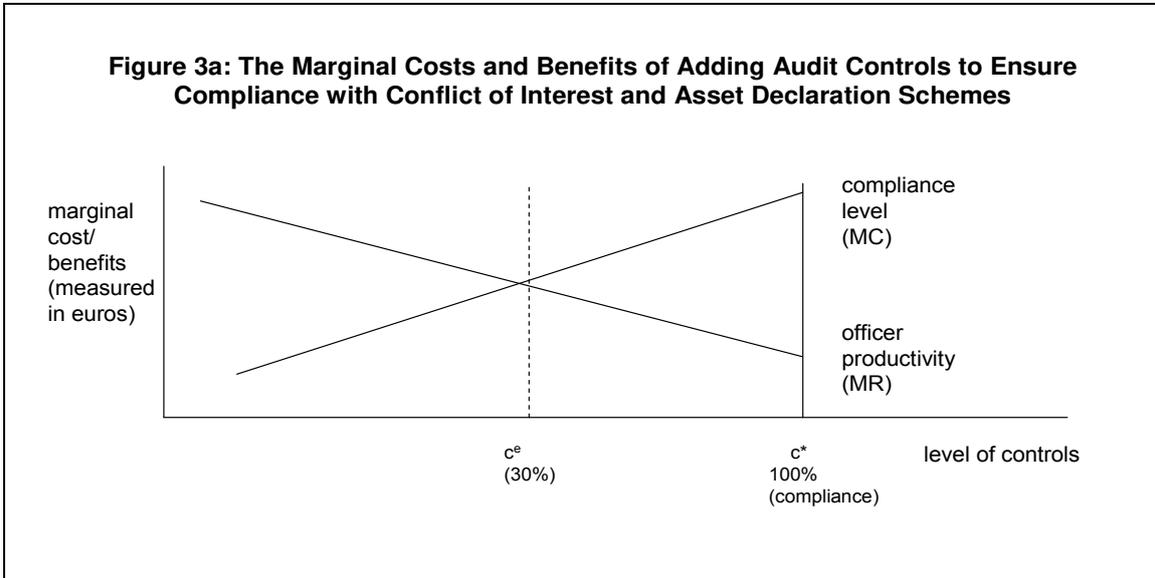
The hardest (and most creative) part of the audit revolves around making recommendations which will address these anti-corruption control failures. The Standards provide little guidance on the exact type of recommendations auditors should provide to their clients – except that recommendations should aim at decreasing risk and generate a net benefit (compared with the cost of implementing the recommendation).<sup>13</sup> In the case of our audit (and contrary to the advice many internal auditors might give), we did not make the conventional recommendation to impose more controls. Instead, we recommended that the Carpatian Customs Agency provide awards or install reward mechanisms to reward individuals for knowing, following and encouraging the adoption of the agency’s anti-corruption regulations. Such a recommendation draws from advances in economic science, and particularly the theory of mechanism design.<sup>14</sup> The literature on compliance indicates that regulations should be “incentive-compatible.” Namely, civil servants should be offered positive as well as negative incentives for compliance.

The optimal level of controls depends on their (countervailing) effects on compliance and productivity. Figure 3a demonstrates the economic logic behind our recommendation for an awards scheme. On the one hand, imposing more controls (such as imposing the obligation that managers check whether all staff have filled conflict of interest and asset declaration forms) would increase compliance. As shown in Figure 3a, the cost of imposing one more control increases as level of controls already in place increases

<sup>13</sup> Recommendations must “add value” (Standard 2000) by reducing organisational risk through “the improvement of governance, risk management, and control processes using a systematic and disciplined approach” (Standard 2100).

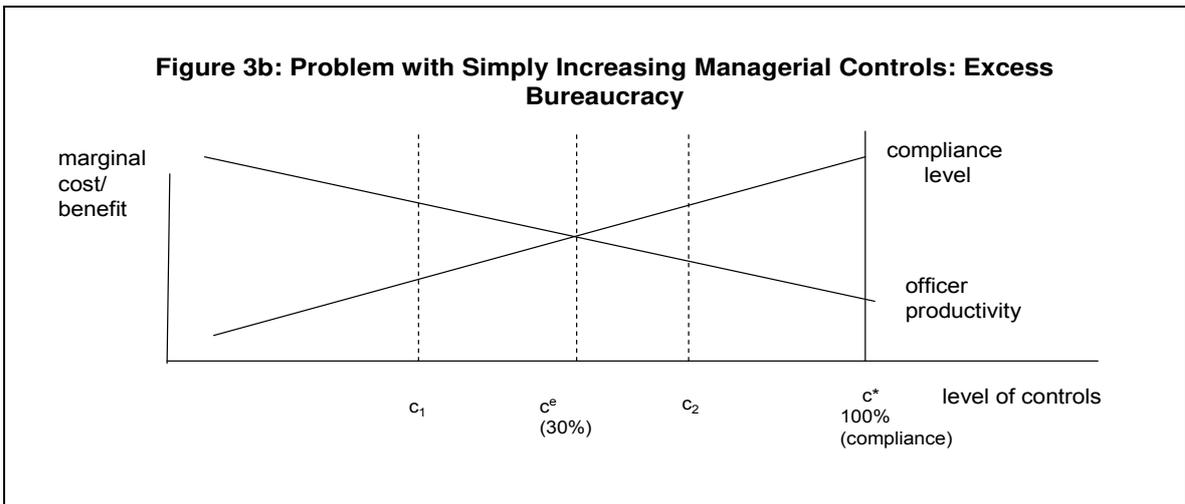
<sup>14</sup> Garoupa and Klerman (2004) provide much of the theory behind the use of mechanism design in deciding on the optimal level of punishment for potential corruption offences.

(representing increasing marginal costs).<sup>15</sup> On the other hand, more controls result in lower productivity – through diverting staff time away from controlling import containers, checking that traders calculate import taxes correctly and so forth. In other words, increases in controls result in lower marginal benefits in terms of customs officers’ productivity. Our survey data show that between 20% and 40% compliance represents the equilibrium – though of course not optimal -- amount of compliance for submitting asset declarations for the level of controls currently in place.

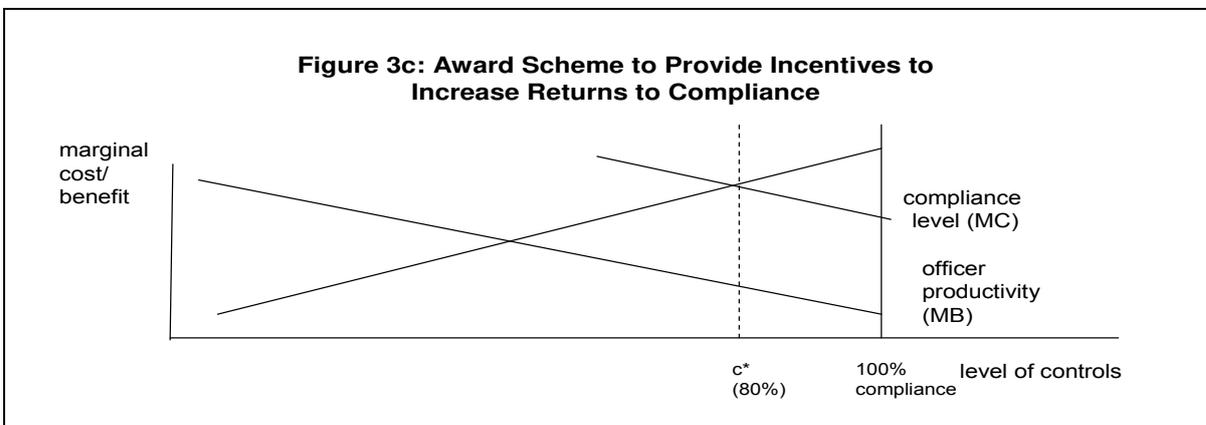


Simply adding controls will not improve compliance with the conflict of interest or asset declaration schemes. Figure 3b shows the equilibrium level of controls, given the marginal costs and benefits faced by Carpatian customs officers. At a level of controls  $c_2$ , the costs of compliance exceed the benefits in terms of increasing customs officers’ productivity. Less productive officers have no incentive to comply with such controls (and their managers have no incentive to force them to comply). As a result, the level of compliance slips back into equilibrium at  $c^e$ . The “extra controls” ( $c_2 - c^e$ ) directly correlate with the level of non-compliance (controls which customs officers do not comply with). Conversely, if management sets the level of controls too low, gains from increased officers’ productivity are “lying on the table” – providing managers with increased incentives to regulate. At the time of our audit, we observed that managers were not trying very hard to increase the number of controls – suggesting over-regulation. The extent of non-compliance found in the data suggests that the level of controls exceeds the equilibrium level.

<sup>15</sup> In order to keep the discussion from becoming too abstract, the practical way the Customs Administration would increase the level of controls (as suggested in Figures 3) would be to add articles to its Regulation on Disciplinary Procedures. Each new article would impose an extra obligation – or add precision to an existing obligation – to collect and check conflict of interest and asset declarations of customs staff.

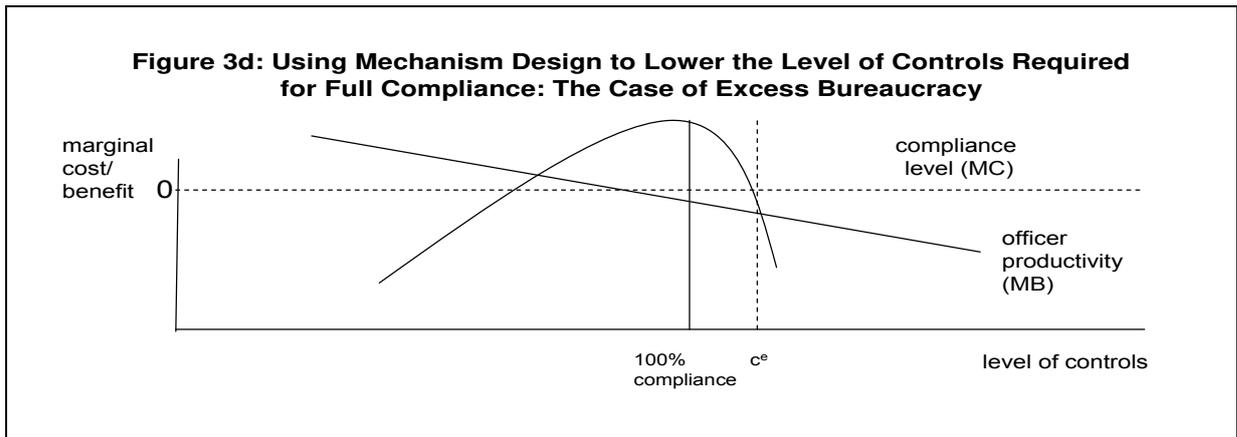


Providing incentives to comply with customs anti-corruption regulations – in the form of an awards scheme – would increase the equilibrium level of compliance. Figure 3c shows the economic logic of such a recommendation as shifting the marginal benefits of compliance out through increased officer productivity. Such productivity gains could result from increased morale or finding ways of complying without the need for heavy-handed bureaucracy. As shown in Figure 3c, such an incentive programme may raise the equilibrium level of compliance to a number like 80%. At the time of this writing, enforcement by the Civil Service Commission (in charge of providing surveillance for the asset declaration and conflict of interest scheme) seemed unlikely. However, if such enforcement did increase, the marginal costs of compliance would shift outward (fall) – thus increasing the equilibrium level of compliance to even 100%.



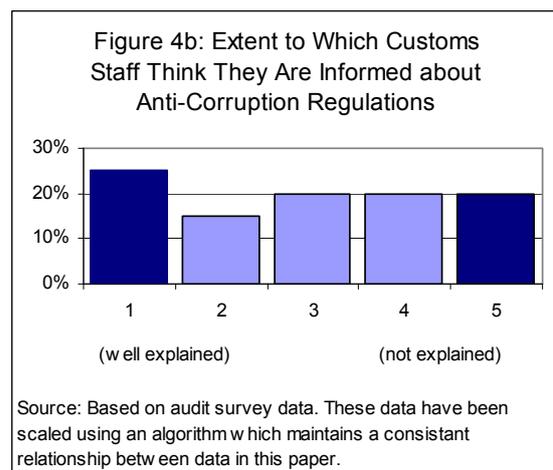
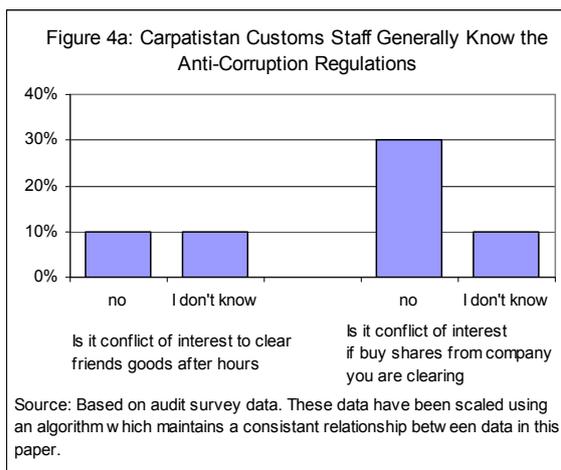
Clearly, the internal auditor – in subsequent performance audits or follow up audits on the recommendation made – should ensure that over-compliance does not occur. An awards scheme, increased enforcement by the Civil Service Commission, and laws increasing administrative liability for non-compliance could result in excessive control. Customs officials would spend too much time ensuring they are 100% compliant – resulting (in practice) in levels of compliance in excess of 100%. Figure 3d shows the logic behind such excessive compliance as the result of defensive compliance. Even after the level of controls ensure 100% compliance with the asset declaration or conflict of interest scheme, individual customs officers may invest extra time and effort in order to make sure they appear as though they are complying. They will make investments in compliance in order to prevent even a low probability finding of being in non-compliance. As a result, their

marginal costs for investing extra effort in compliance drops (relative to their expected returns) and excessive control results.<sup>16</sup>



### *Ignorantia Juris Non Excusat*

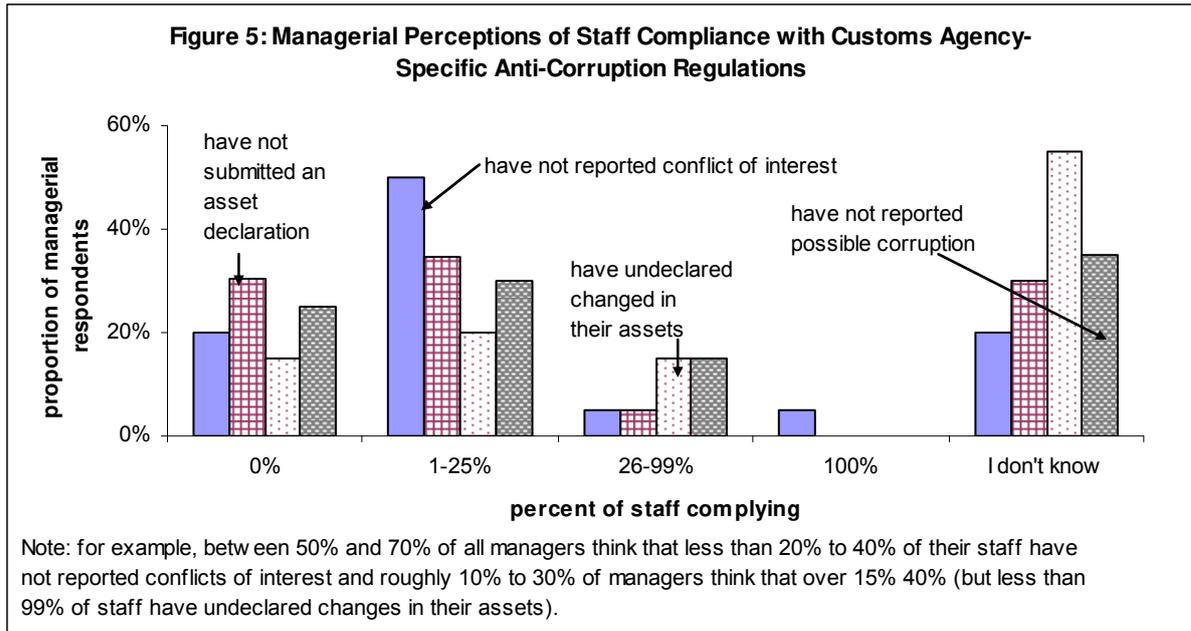
While *ignorantia juris non excusat* (ignorance of the anti-corruption regulations in place does not excuse non-compliance), such ignorance may explain non-compliance. Such explanations form the basis of an internal auditor’s recommendations. Figures 4 show the results of a test of customs staff’s knowledge of specific regulatory prohibitions. As shown in Figure 4a, between 5% - 20% of Customs staff would either improperly clear goods of a friend (or don’t know if they should or not). Roughly between 35% and 55% of Customs officers would either improperly buy shares of a company they are clearing (or don’t know if they should or not). Thus the data, overall, show that customs officers generally know about the provisions contained in the law and the customs agency’s anti-corruption regulations. However, Customs staff do not know if they know the regulations. Figure 4b shows the extent to which Customs officers think they know anti-corruption regulations. As shown in the figure, almost equal proportions of Customs officers feel they know the regulations well as those that do not.



No compliance audit would be complete without a test of the controls of systems of managerial assurance. Simply put, Customs house managers can not help ensure the compliance of their staff unless they receive regular updates about the submission of (or

<sup>16</sup> See Helm (2006) for a more complete formulation of this phenomenon.

problems with) new asset declarations or conflict of interest statements from their staff. Figure 5 shows that between 20% to 40% of managers don't know if customs staff have submitted an asset declaration form or declared changes in their assets. Assuming that customs staff responded truthfully to the questionnaires used to create Figure 1 (about their filling in conflict of interest forms and asset declarations), managers should have guessed that the percent of staff complying rests between 26% to 99%. The stated rates of compliance for filling in conflict of interest declarations rest at 84% and 31% for asset declarations. As such, over 90% of managers guessed incorrectly about the compliance of their staff with customs anti-corruption regulations. Clearly, managerial assurance in the area of compliance with customs anti-corruption controls requires improvement.



In this case, the cheapest and most effective control to put into place requires the person in customs headquarters who receives these declarations to provide updates to all customs managers about the their staff's compliance with the Agency's anti-corruption regulations (or develop systems to collect data on such compliance). Our cost-benefit analysis showed that such a recommendation would generate €270,000 in overall benefits (higher than any of the alternative recommendations might have generated).<sup>17</sup> Such an example represents a control deficiency (the lack of a regulation which should be present) and can be easily remedied (in the first instance) by the stroke of a pen.

### Assessing the Culture of Compliance and the COSO Framework

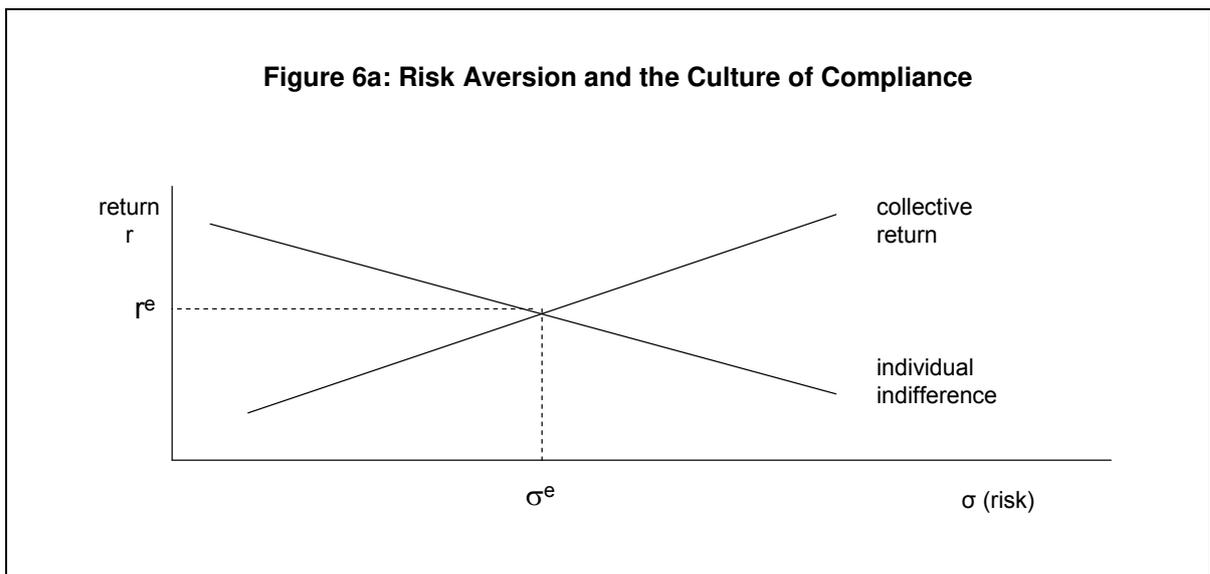
Unlike specific engagements (such as checking if the importers' computer systems work properly), anti-corruption audits should assess the overall organisation's "control environment" – namely its culture of compliance.<sup>18</sup> Such audit standards developed in 1992 precisely in response to audit failures in the USA stemming from these audits' failure to detect and/or prevent corruption. At that time, the Committee on Sponsoring Organisations or COSO – a body of audit agencies and experts convoked to discuss ways of improving audit performance on engagements (such as compliance with the Foreign

<sup>17</sup> We do not discuss the cost-benefit calculations created for each audit recommendation due to lack of space. By now, such calculations have become commonplace during regulatory drafting and performance/compliance audits of these regulations.

<sup>18</sup> See Rezaee (1995) for more on COSO and the auditor's role in fighting corruption.

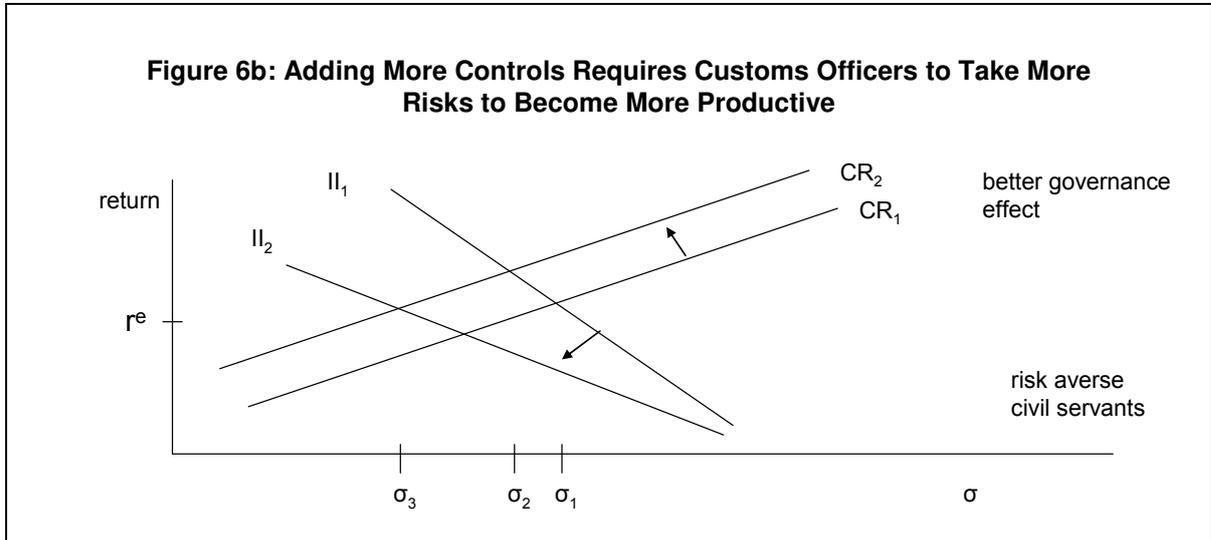
Corrupt Practices Act) – recommended the assessment of an organisation’s attitudes, morale, and general corporate culture. These assessments aim to establish the overall risk that management devotes insufficient time and resources toward establishing risk-based controls for fraud and corruption. However, measuring such a culture of compliance poses significant difficulties in the internal audit paradigm.

Concepts from the social sciences can help conceptualise and measure the culture of compliance. The imposition of anti-corruption controls (like all controls) seeks to increase risk-adjusted returns. Processes “under control” (exhibiting little variation in performance or outcomes) have higher quality over-time (Tarantino, 2008). As shown on the horizontal axis of Figure 6a, the standard deviation of a process – denoted by the Greek letter sigma or  $\sigma$  – represents risk (as the variation in a process such as the time customs officers require to check a particular risk profile in a red channel search). Figure 6a shows the upward sloping relationship between risk and return. As customs officers take more risks in implementing new practices, conducting more searches of suspicious vehicles and so forth, the average return to the entire Customs Agency rises. However, individual customs officers can be assumed to be risk averse – lower levels of risk correspond with higher personal gains (particularly in an administrative environment that punishes instead of rewards smart risk-taking behaviour). The required increased gains needed to convince the individual customs officer to take extra risks can be plotted by a downward sloping indifference curve. The equilibrium level of risk and return for the Customs Agency will be given at a point where institutional incentives match personal ones – for an equilibrium return and risk at  $(r^e, \sigma^e)$ .

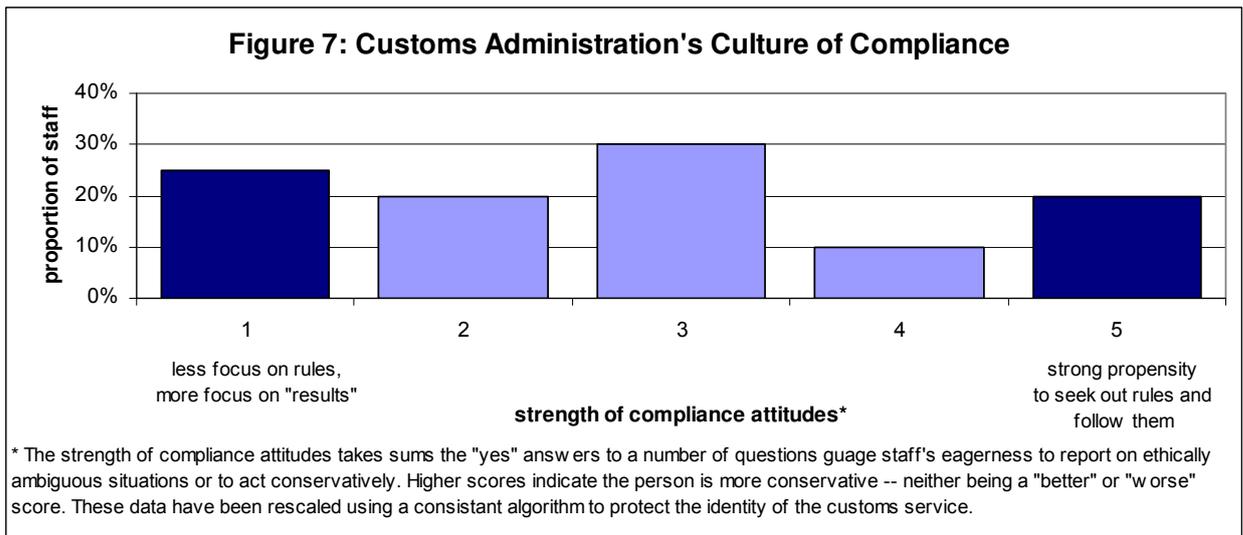


A system of inexpensive controls may decrease overall risk without compromising return. As shown in Figure 6b, the imposition of controls – such as mandatory oversight of all asset and conflict of interest declarations – will shift both curves. These controls will raise the overall level of returns for all levels of risk (otherwise why install the controls in the first place?). Figure 6b portrays such a gain as an upward shift in the collective return line (CR – as shown in Figure 6a) from  $CR_1$  to  $CR_2$ . On the other hand, risk averse customs officers’ performance will chafe under the increased level of rules – as they need time to comply and probably feel some resentment from more surveillance. Figure 6b shows such an effect as the counter-clockwise rotation of the individual incentives curve (II – as shown in Figure 6a) from  $II_1$  to  $II_2$ . As shown in Figure 6b, while the exact effect on risk and return will depend on the shape of each curve, the net effect of imposing more

controls will lead to decreased risk to the Customs Administration while keeping overall returns at the same level. If  $s_1$  represents the level of risk before the imposition of controls,  $s_2$  represents increased risk-adjusted returns from better government, and  $s_3$  represents the decreased risk to individual customs officials from complying with extra regulations – then the imposition of controls unambiguously reduces risks. And controls increase risk-adjusted returns.... just like they should.

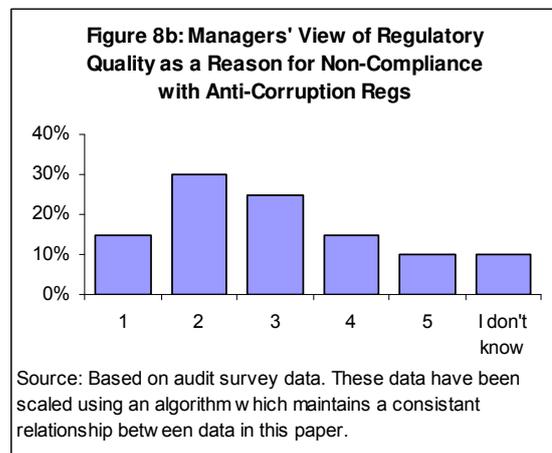
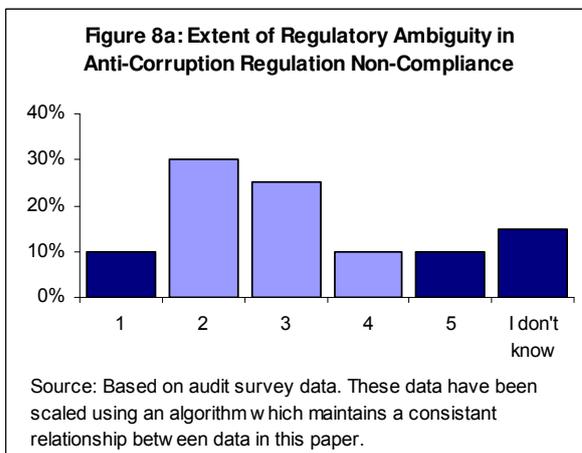


Techniques from the social sciences can help the internal auditor to construct an index of such a culture of compliance. The culture of compliance – as envisioned by the COSO standard – represents a tacit or “constructed” variable. The researcher measures the tacit or unobservable variable by asking a number of survey questions addressing the concept the researcher wishes to measure, and uses some mathematical algorithm on the resulting data to construct an unobservable variable (Chia and Koh, 2007). Despite their problems, the creation of such tacit or constructed variables comprises the standard way researchers deal with hard-to-quantify concepts (like culture). In the case of our anti-corruption compliance audit, we sought to measure the extent of risk aversion among Carpati customs officers. As theory tells us (as shown in Figure 6a), more or less risk aversion – or controls following – does not necessarily result in better or worse performance. Such decisions emerge as the result of tastes and technology. As shown though in Figure 7, roughly 20% of staff are not risk-averse and seek to exercise their discretion. Roughly between 5% and 25% seek approval or seek permission for most decisions. The majority of Carpati Customs Agency staff fall somewhere in the middle – suggesting that the Agency has a culture of compliance which is neither excessively compliant nor dangerously “free-wheeling.” In short, nothing about the customs agency’s organisational culture explains the reasons for the relatively wide-spread non-compliance seen in the data.



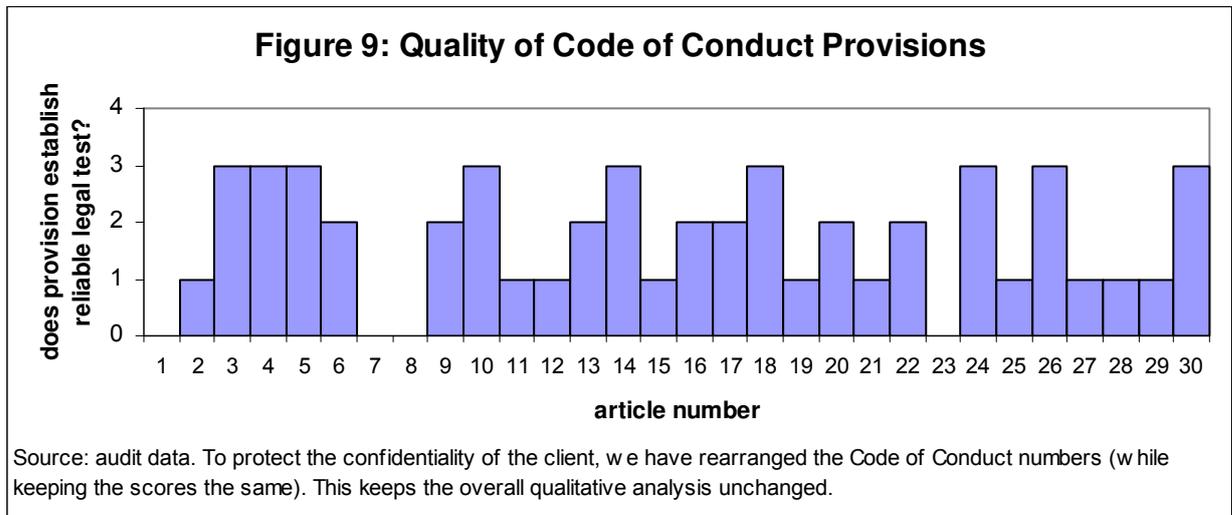
### Testing for Control Deficiencies (Regulatory Failure)

Neither customs managers nor staff thinks that poorly written regulations result in non-compliance with the Customs Agency's anti-corruption regulations. As shown in Figure 8a, customs employees have difficulty determining if anti-corruption regulations are unclear or ambiguous. Roughly 5%-25% strongly disagree that regulations have been poorly written. About 10% to 30% of employees however strongly agree that "regulatory failure" has occurred – namely that regulations are poorly written and distributed. Around 50% (plus or minus a large margin) find these reasons as relatively unconvincing. Interestingly, as shown in Figure 8b, almost exact same proportions of managers find that regulations are poorly written (about 10%) while another 10% strongly disagree. Again, about 50%-ish are relatively ambivalent about regulatory quality.

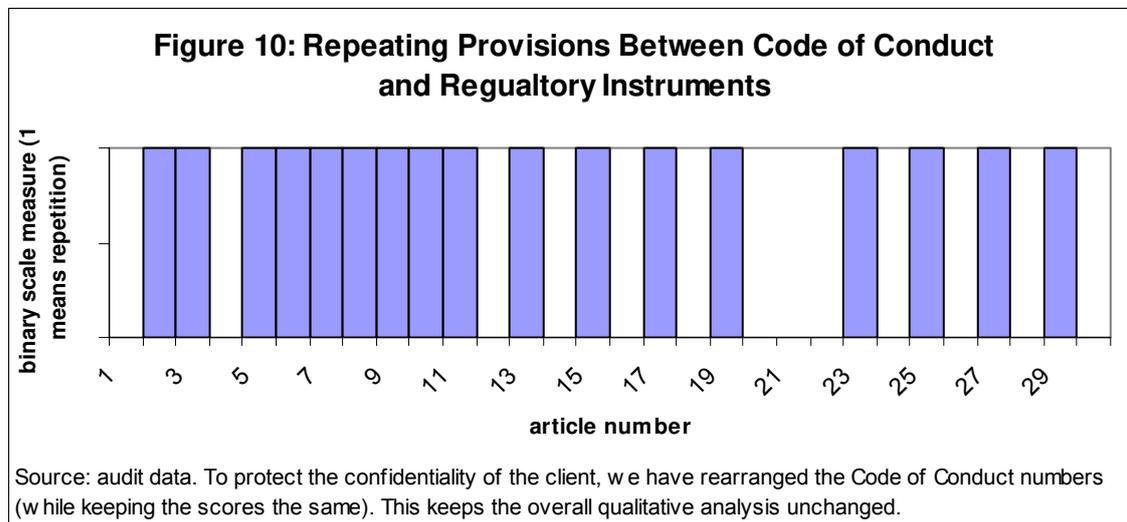


In contrast to the techniques discussed earlier for assessing anti-corruption regulatory quality, Standard 2310 (in practice) requires auditors to check for themselves – or 'vouch' in audit terminology – the interview statements. The majority views of Carpatistani Customs Administration managers' and staffs' opinions about regulatory quality are at variance with the auditors' opinion about the quality of the customs agency's anti-corruption regulations. Figure 9 provides an index of the reliability of the provisions contained in the Code of Conduct Regulation – with 3 being the most reliable and well-defined; whereas 1 is the least well defined. A score of zero indicates that the provision does not provide a valid legal obligation. As shown, only about 5 articles out of 30 (or

roughly 30%) provide a basis for guiding customs officers' conduct. **We note that Carpati Customs management disagrees with our assessment.**<sup>19</sup>



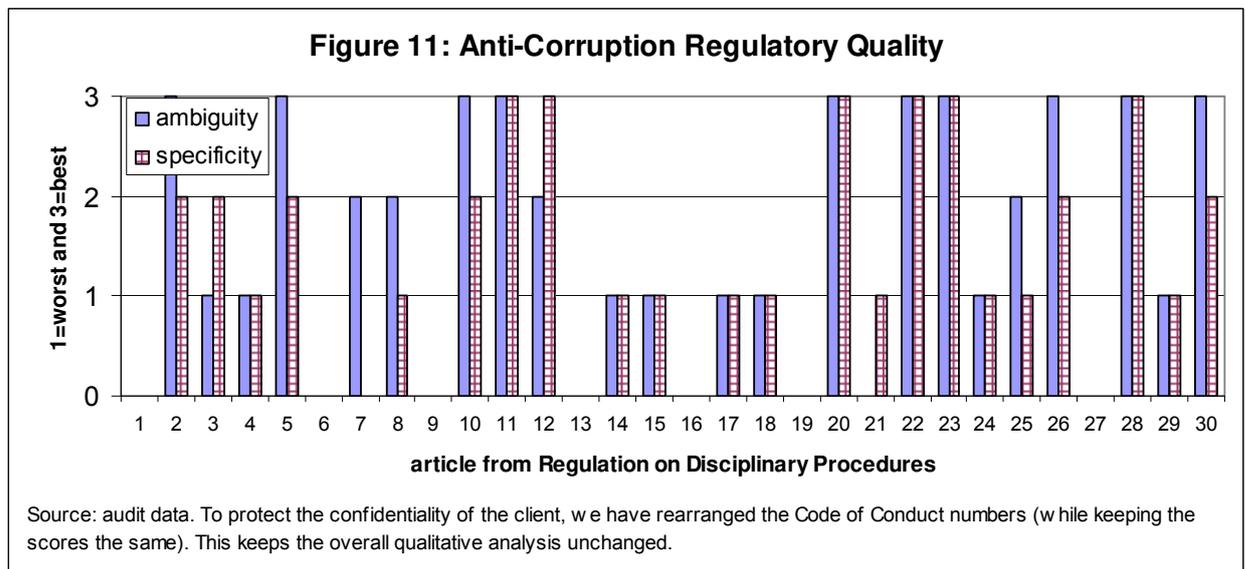
The repetition of controls signals that either control deficiency (the control was poorly designed) or poor regulatory drafting skills – or usually both. Indeed, the Code of Conduct Regulation already contains many of the provisions contained in the Regulation on Disciplinary Procedures. Figure 9 marks the specific repetitious articles -- showing that 12 out of 30 (about 30% to 60%) of the provisions repeat the content of the Code of Conduct without further precision. In principle, the Code of Conduct should provide the general principles which are further elaborated in the Regulation on Disciplinary Procedures. In practice, the two regulatory instruments fail to provide adequate and specific instructions – accounting for much of the control failure observed in practice.



Poorly designed controls also indicate a high risk of control failure (that the control fails to mitigate the risk the control aimed to reduce).<sup>20</sup> Ambiguous and abstract controls usually

<sup>19</sup> In a final auditor's report, the client (and other relevant managerial or supervisory staff) can make comments or disagreements with the auditor's findings. Unlike the assessments conducted in the *ad-hoc* controls studies approach (which are negotiated with the client and represent a single view), an auditor's report may present two opposing views on a recommendation – providing the reader with an independent and objective (and even possibly wrong!) view.

suggest poorly designed controls which are likely to fail. Figure 11 shows the regulatory quality of the Regulation on Disciplinary Procedures, as defined by the ambiguity of its various articles and their specificity. Ambiguity measures the extent to which the article tells the employee “what to do”. Specificity refers to “how to do it.” Again, a 1-3 scale is used -- where 3 represents the best score and 1 comprises the worst score. As shown, only about 10% or more of the provisions in the regulation contain – according to the auditors opinion – an acceptable basis for regulating customs officers’ conduct.



Again, the social sciences – specifically organisational theory -- provide models useful for making audit recommendations. The classical audit response to the weak controls identified above might be to propose a more elaborate set of instructions for staff. However, such recommendations would ignore the organisational environment and the extent of the institutionalisation of previous informal practices. While organisational interpretations may vary, the audit team determined that Carpatistani Customs works in a fast moving organisational environment (with rapidly changing laws as the country prepares for adopting a range of new laws, the existing economic crisis of the early and mid-2000s and so forth). As shown in Figure 11, the types of problems customs officers had to deal with generally are standardised (import procedures usually follow a specific routine, most forms are standardised – and so their work is concrete). In this environment, the optimal control regime should focus on specific, but flexible controls (Denhardt, 2000). As such, the audit team recommended that the Regulation on Disciplinary Procedures be expanded to provide for guidance – but supplemented mainly by practical posters and other guidance. The general principles contained in a typical Code of Conduct and need for highly advanced moral reasoning skills required of lawyers (or accountants!) are not required for customs officers. The audit team also (naturally) recommended the elimination of redundant controls.

<sup>20</sup> In the internal audit methodology, the audit team – after looking at the inherent risk of the area being audited, then looks at the quality of controls -- and then focuses its field-work (testing or probing) on areas covered by weak controls. In high corruption risk areas where controls are likely to fail, the audit team must spend more time and resources conducting fieldwork in order to assess whether bribes or other forms of corruption have occurred.

**Figure 11: Type of Controls Corresponding to Type of Organisational Environment**

work process type	Organisational environment	
	fast	slow
abstract	dynamic government organisation (general, abstract controls covering high-risk areas)	advanced, evolving government (specific controls governing only specific parts of work)
concrete	transition government (specific but flexible controls or contingency-based controls)	classical bureaucracy (specific, elaborate controls/regulations)

Source: adapted from Denhardt (2000)

### Fitting Internal Audit into the Broader Debate on Anti-Corruption Regulation

In a public sector audit – particularly an anti-corruption internal audit – a solid grounding in the social sciences (economics, politics, and sociology as well as management) provides the basis for the audit. In order to receive accreditation by the Institute of Internal Auditors, the internal auditor must have passed a series of exams to receive a Certificate in Internal Audit (CIA) covering the material roughly on an Masters of Business Administration -- including strategy, IT, operations research. However, government auditing does not have such a curriculum. Candidates for a certification as in Government Auditing Professional know the Standards, and other bits related to government accounting and structure. However, as Lowensohn *et al.* (2007) find in their review of the literature, auditor specialisation correlates with perceived audit quality.<sup>21</sup> Standard 1210 requires the audit team to have collectively the specialist skills to complete the audit.

Such findings militate against the use of “toolkits” or “assessment tools” in assessing the performance of anti-corruption regulations. The IMF’s Reports on the Observance of Standards and Codes and the United Nations’ attempts at providing “toolkits” to assess the quality of compliance with anti-corruption regulations provide obvious examples of what auditors would call control self-assessment questionnaires. The Global Integrity project represents the most developed form of such control self-assessment – where attribute sampling checks “in law, is there a national customs and excise agency?” in over 60 countries. The use of such surveys eliminates the creativity involved in creating recommendations (a basic principle of internal audit).<sup>22</sup> Aside from the basic methodological problems inherent in such benchmarking – as addressed by authors such as Sampford (2006) -- such benchmarks and “empirics” also represent the most harmful part of the “audit culture” permeating the public sector -- as decried by authors such as Hood *et al.* (1998) and Anechiarico and Jacobs (1996).

Internal audit, on the other hand, provides a disciplined methodology for assessing the performance of anti-corruption work within a state organisation. Standard 2100 sums up succinctly the role of internal audit – “the internal audit activity must evaluate and contribute to the improvement of governance, risk management, and control processes using a systematic and disciplined approach.” The internal audit activity requires creativity and knowledge – not a standard toolkit – to achieve this improvement. However, the

<sup>21</sup> Gendron *et al.* (2007) provide a valid critique of this approach. They argue (in the case of Canada) that the audit agency created the appearance of expert knowledge which it used to bolster the strength of its recommendations.

<sup>22</sup> Smith’s (2007) recent proposal for the benchmarking of ethics programmes across all civil services clearly represents the culmination of the benchmarking fad.

internal audit approach can not help the audit team identify anti-corruption risks – where studies from the social sciences such Rose-Ackerman (2006) and Reinikka and Svensson (2006) proved invaluable to our own work. The internal audit approach can not develop recommendations based on theory and tested empirically in contexts wider than in the particular engagement – and studies such as Mungiu (2006) and Nonchev (2006) provided most valuable. Finally, the internal audit approach can not assist when considering the administrative and party-level politics which would affect a recommendation – and studies such as Lawson (2009) provide such useful guidance. In short, internal auditing standards provide the framework and the social sciences provide the reasoning behind audit recommendations.

## Conclusion

The internal audit of controls requiring civil servants (such as customs officers) to declare their income (and any substantial changes) as well as potential conflicts of interests represents a major element in the fight against corruption. To date, the four previous methods of evaluating anti-corruption regulatory performance – the systems design approach, the *ad-hoc* controls studies approach, the descriptive legal analysis approach and the prescriptive manuals and handbooks approach – can not provide specific guidance in a specific circumstance. The anti-corruption compliance audit – particularly focused on the submission of conflict of interest declarations and asset declarations – can form the basis for creative recommendations which add more value than they cost to implement. The internal audit approach – as enshrined in the International Standards for the Professional Practice of Internal Audit (ISPPA) – can serve as a more valuable basis for evaluating the performance of anti-corruption regulation than the numerous *ad hoc* toolkits and measurement tools currently available online. More generally, with a greater understanding of the role and methods of internal audit in the social sciences, internal audit – and particularly audit findings – can contribute to practical questions being posed in the social sciences and the anti-corruption literature.

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