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THE IMPACT OF COSO INTERNAL CONTROL ON CORRUPTION: A THEORETICAL TRIANGULATION PERSPECTIVE

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ABSTRACT

This study empirically examined the effectiveness of internal control in tackling corruption in government funds. The research adopted a qualitative approach and selected two similar governmental organisations as case studies.

The study concludes with an assertion that the extent to which internal control is effective in tackling corruption depends on how the internal controls are initiated and enforced. As shown in the first case study, establishing an institution with a culture which implies that ethical behaviour is the norm increases the likelihood that hard and efficient monitoring anti-corruption controls will be effective, thus helping to reduce corruption levels. However, as in the second case study, if the culture of the organisation appears to be tolerant towards corruption, the hard control and monitoring mechanisms are unlikely to be as effective, leading to higher levels of corruption than in an organisation where such practices are considered to be less acceptable.

Key words: internal control, bureaucratic corruption, agency theory

INTRODUCTION

Research that analyses the causes of, and prospective cures for, corruption can be categorised into the following two groups. The first group represents research that relates corruption to what can be called “societal factors”, such as religion and type of political system. The second group of research analyses the effects of what this study calls “organisational factors” on corruption, such as salary scale and internal control.

Although internal control is often mentioned in the literature as a tool to fight corruption, limited empirical research to date has been conducted to examine the relationship between internal control and corruption in governmental organisations.

This study has made a distinctive theoretical contribution to the corruption literature by showing that the degree of successful implementation of anti-corruption measures guided by the principal-agent model depends on the quality of a clean, active and powerful principal. Furthermore, the research has demonstrated how theoretical triangulation can be a very powerful tool in understanding the nature of corruption, as alternative corruption theories can be complementary to each other and offer not only different diagnostics of corruption, but also different solutions.

RESEARCH QUESTION

This study aims to answer the following question: To what extent is internal control effective in tackling corruption in government organisations?

DEFINITIONS OF KEY TERMS

In a broad sense, internal control is one of the foundations of sound governance. It consists of a set of management tools that are designed to provide reasonable assurance regarding the accomplishment of an organisation’s objectives. Typical examples of internal control include: internal audit, standards of conduct, and segregation of duties. It is vital to note that the

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definition of internal control has changed considerably in the last 20 years. Nowadays, internal control is used not only in accounting and finance, but also covers all areas of an organisation, including quality of governance (Committee of Sponsoring Organisations of the Treadway Commission (COSO), 2013). Corruption, as defined by Transparency International (2013), is “the abuse of entrusted power for private gain”.

THEORETICAL FRAMEWORK FOR THIS STUDY

This research used insights from historical institutionalism, agency theory, and rational choice neo-institutionalism, and applied them to the studies at hand. This does not mean that it bought into all of their assumptions; however, it used these three approaches to understand what happened in the contexts of both funds in order to capitalise on the strengths of each approach, and to overcome the weaknesses of each of them.

HYPOTHESES

Based on the study’s theoretical framework and relevant literature review, the following hypotheses were developed:

H1: an effective internal control leads to a lower perceived level of corruption in government organisations.

H2: an effective internal control leads to a lower perceived level of corruption when there is an active principal.

H3: an effective internal control leads to a lower perceived level of corruption when there is a clean principal.

H4: an effective internal control leads to a lower perceived level of corruption when there is a powerful and independent principal.

H5: an effective internal control leads to a lower perceived level of corruption when the corruption equilibrium is low.

H6: an effective internal control leads to a lower perceived level of corruption when it was established appropriately.

H7: the effectiveness of internal control in tackling corruption is better understood with theoretical triangulation.

CASE STUDY SELECTION

The most similar systems design is employed as a research strategy; therefore, the study selected and examined only cases with the most similar features (variables). These features were held constant in order to identify dissimilarity between cases and adduce any potential causes of difference between the variables concerned (Lijphart, 1971; Marsh and Stoker, 2010).

In order to keep the “societal factors” constant, all cases were selected within one country (Saudi Arabia), so they were all examined within the same culture and under the same political, legal and economic system. This is because comparing two government institutions in two different countries is less meaningful as, for instance, the judiciary or police might play a useful role in tackling institutional corruption. Therefore, corruption could be less in one government institution in comparison to another in a different country, not because of internal control, but because of powerful law enforcement and the criminal justice system.

However, the most challenging task was to select case studies within Saudi Arabia with the same level of salary, job security, employment of women, business risks, state ownership, competition, and officials’ discretion.

The initial plan for this research was to select two government agencies and two state enterprises as units of analysis. However, after scrutinising all state enterprises, the study was not able to find two cases with similar levels of competition, salary scale, and complexity of

business. Therefore, and as illustrated in Figure 1, two government funds² in Saudi Arabia were selected as the research sample. To protect the anonymity of the interviewees, the two funds were given the fictitious names of “Fund A” and “Fund B.”

Figure (1): Case sample for this study

Case	Independent variables								Dependent variable
	Internal control	Salary scale	Job security	Employment of women	State ownership	Competition	Level of risk	Officials' discretion	Corruption
Fund A	?	Medium	High	None	Full	Low	Medium	Medium	Low
Fund B	?	Medium	High	None	Full	Low	Medium	Medium	Medium

The dependent variable for this study is the level of corruption. It is derived from the Saudi Arabia Corruption Index. Fund A is ranked as the least corrupt among 37 government organisations in the index whereas Fund B is perceived as having a medium level of corruption in comparison with all government organisations. In line with Transparency International's Corruption Perception Index, the Saudi Index rates government organisations on a scale of 0 (highly corrupt) to 100 (very clean). The average score in the index is 80.

DATA SOURCES

The main data collection sources for this study were the Saudi Corruption Index, semi-structured interviews, observations, and document analysis. The Saudi Corruption Index was employed to measure corruption while in-depth semi-structured interviews, observations, and document analysis were used to analyse and evaluate the quality of internal control in government organisations.

The process of structuring interview questions and document analysis was guided by the updated edition of the COSO internal control framework (2013). This framework facilitates the evaluation of the effectiveness of internal control in government organisations. In accordance with the COSO framework (2013), an effective internal control means that each of the components mentioned in the COSO (control environment, risk assessment, control activities, information and communication, and monitoring activities) and all of their 17 relevant principles are present and functioning, and that the components are operating together.

TRUSTWORTHINESS

To maximise dependability, confirmability and credibility in the data collection and analysis, this research adopted the following strategies. First, it triangulated interview and documentary data from multiple data sources, from multiple contexts, and across multiple informants. Secondly, this study developed and strictly adhered to a data collection protocol in order to achieve the following:

(1) assuring interviewees that all information collected during the study would be solely for research purposes and kept strictly confidential; therefore, they would suffer no adverse consequences from being honest and transparent with the researcher;

² A “government fund” is not a term with which many people in the UK are familiar, but essentially it is the way in which the government invests its funds in a particular (and usually important) sector of the economy in order to boost production where leaving the funding to the free market might result in a lower level of economic activity. In essence, they are supposed to provide short-term subsidies to industry for long-term economic gain.

(2) highlighting to all participants in this study the importance of being precise and accurate not only to benefit Saudi Arabia but also to enrich the literature on corruption prevention mechanisms;

(3) building trust with respondents by being very transparent and providing them with the following information before any interview: “who I am”, “what the nature of my research is”, “how the data will be used”, “where the results will be disseminated” and “whether the information will be attributed or anonymous” (Harvey, 2011, p. 433);

(4) asking interviewees to review, refine and approve interview transcripts to ensure their accuracy and precision; this step has helped to maintain the objectivity of the research; and

(5) explaining to all participants their right to withdraw from the interviews at any time and without any justification.

RESEARCH FINDINGS

The most important finding of this research is that implementing effective internal controls in accordance with the COSO Internal Control Framework in government institutions leads to lower levels of corruption; however, implementation of such internal control is more likely to succeed in tackling corruption if policymakers look for insights from the following corruption theories: agency theory, rational choice neo-institutionalism, and historical institutionalism. These theories should be considered as complementary to each other, not as competing theories, even though their explanations of corruption are different, and sometimes clash with one another's. However, in many cases, including in the case studies of both funds here, these theories provided complementary explanations on the impact of internal control on corruption, as will be seen throughout the following sections.

AGENCY THEORY EXPLANATION OF HOW INTERNAL CONTROL IMPACTS CORRUPTION

A scholar of agency theory would explain that the low levels of corruption in Fund A, compared to Fund B, was caused by the relative cost of corruption within the two funds. This approach focuses on the hard, monitoring internal controls, and states that if policy makers raise the cost of engaging in corruption, they will lower the level of corruption.

An overall assessment of the cost of corruption in both funds lead to the conclusion that for an official in Fund A, there is a higher chance of being caught, fired and prosecuted than in Fund B, which explains why the levels of corruption are lower in Fund A.

The hypotheses that relate to agency theory are the following:

H2: an effective internal control leads to a lower perceived level of corruption when there is an active principal.

H3: an effective internal control leads to a lower perceived level of corruption when there is a clean principal.

H4: an effective internal control leads to a lower perceived level of corruption when there is a powerful and independent principal.

Figure 2 summarises the most important evidence that this study sets out to support these hypotheses.

Figure (2): Examining internal factors in the principal-agent model

Agency pillars	Fund A		Fund B	
	Importance in reducing corruption	Evidence ³	Importance in reducing corruption	Evidence

³ Evidence to show how this assumption affected the levels of corruption.

Active principal	Medium to High	<ol style="list-style-type: none"> 1. Consistently employing one of the “Big 4” accounting firms as an external auditor 2. Approving and maintaining state of the art policies and procedural manuals 3. Sustaining intensive training programmes for almost all officials (no person was promoted to senior management without going through these training programmes) 4. Although internal auditors were empowered by the board (e.g. enough staff, incentives to take international recognised professional certificates), the internal audit report goes to the board through the agent (the director general), but the agent never edited the report 	Low	<ol style="list-style-type: none"> 1. Consistently employing one of the local accounting firms as an external auditor 2. Approving and maintaining inadequate policies and procedural manuals 3. Internal audit reports are modified by the agent (the director general, who is a member of the audit committee)
Clean principal	High	<ol style="list-style-type: none"> 1. Consistently recruiting agents with strong integrity credentials 2. All board members were senior government officials who have no business interest in the fund 	Low	<ol style="list-style-type: none"> 1. Some board members had financial interests as they are businessmen and have outstanding loan applications 2. Some board members recruited their relatives into the fund
Powerful and independent principal	High	The board is totally independent of the agent, and therefore in theory it was in a better position to monitor and hold the agent accountable to the policies and procedures	Low	The board was not independent from the agent as the agent (the director general) was the vice-chairman of the board

Taking into consideration that Fund A had better institutional incentives (i.e. hard control) than Fund B, this could explain the different levels of corruption in both funds from an agency theory perspective. Yet this does not tell us the whole story as it was clear through the analysis of both cases that what the rational-choice institutionalists would call “corruption equilibrium” (i.e. the behaviour of others as an incentive) also matters in determining the levels of corruption.

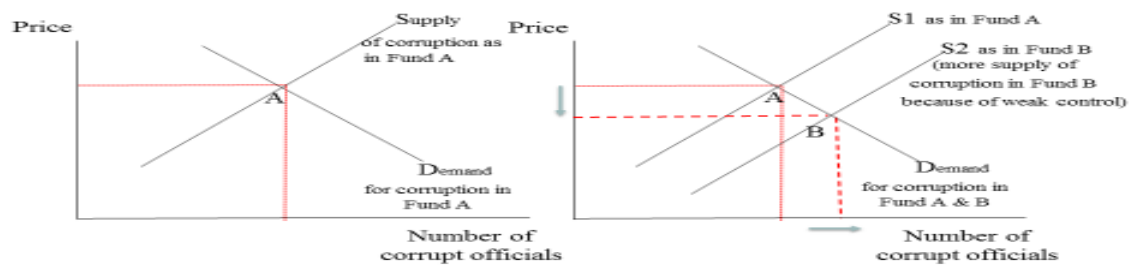
THE RATIONAL CHOICE NEO-INSTITUTIONALISM EXPLANATION OF HOW INTERNAL CONTROL IMPACTS CORRUPTION

Rational choice neo-institutionalism also makes the assumption that actors are always rational and carry out a cost-benefit analysis prior to making a decision – such as whether or not to engage in corrupt practices. However, the theory also suggests that individuals in a large or small group must work together to attain the group’s objectives. Thus, rational choice neo-institutionalism introduces the concept of a corruption equilibrium within an institution to explain how the level of corruption within two broadly comparable and similar institutions (such as Fund A and Fund B) can have such different levels of corruption. A rational choice scholar would say that in Fund A, the corruption equilibrium is lower, hence there is a lower level of corruption, and that in Fund B the equilibrium is higher, hence the level of corruption is higher.

Figure (3) illustrated how internal control influenced the levels of corruption of both funds, assuming that: (a) there were more corrupt officials in Fund B than Fund A; this assumption is based on the number of corruption cases in each fund, and on the Saudi Corruption Index; (b) there is fixed demand as everyone wants to get access to this government fund; and (c) the supply of corruption is influenced by the effectiveness of internal control, i.e. the more effective the internal control, the lower the numbers of corrupt officials:

Figure (3) Corruption equilibrium in both funds

Corruption equilibrium from rational choice neo-institutionalism



Based on the analysis shown in Figure (3), it is apparent how the costs and benefits of corruption in government organisations are determined by the corruption equilibrium or the extent of corruption.

In Fund A, the low levels of corruption themselves increased the cost of corruption not only because Fund A's officials trust or perceive that their colleagues will not engage in corruption, as emphasised by many collective action scholars, but also because corrupt officials will find it hard to indulge in corruption without being prevented, detected and punished. Corrupt officials are prevented because of Fund A's rigid checks and balances, such that every loan application has to be approved by different officials from different departments within the fund. So, in order to circumvent these rigid checks and balances, corrupt officials must corrupt (or collude with) other officials (to overlook corrupt decisions) within other departments. This is unlikely to occur when taking into consideration the institutional integrity of the fund. Assuming that corrupt officials were able to override the checks and balances, there is high probability of being detected by the internal audit department, as internal auditors are empowered and highly trained to uncover non-compliance cases.

By default, the increased costs of corruption in Fund A would lead to higher benefits of being corrupt, as corrupt applicants will find a very limited number of officials who are willing to risk their future in exchange for corrupt decisions.

The same analysis could be applied to Fund B to show why the corruption equilibrium there is higher than in Fund A.

Based on the analysis of both funds, it could be argued that an organisation with high levels of corruption will, assuming nothing significant changes, always have high levels of corruption, considering that the operation of anti-corruption mechanisms depends on the corruption equilibrium within both funds. Therefore, one finding of this research is that as the number of officials who are acting honestly increases, the likelihood of anti-corruption mechanisms working increases, and vice versa. This supports the hypothesis *H5: an effective internal control leads to a lower perceived level of corruption when the corruption equilibrium is low*.

However, this theory provides little explanation of how institutions attained their different levels of corruption in the first place, where Fund B employed a large number of corrupt officials, nor how Fund A was successful in keeping the number of corrupt officials

employed in the Fund to such low levels. Essentially, it still makes the assumption that history does not matter, although it does at least acknowledge that the equilibrium of an organisation can change, slowly, as actors respond differently to changes in the costs of engaging in corruption and the benefits of acting honestly and with integrity. However, it is the historical context of an institution that provides the base of the third theory of corruption – historical institutionalism.

THE HISTORICAL INSTITUTIONALISM EXPLANATION OF HOW INTERNAL CONTROL IMPACTS CORRUPTION

Historical institutionalism has as its fundamental feature the idea of path dependency. This theory states that once an organisation is set on a path towards a particular level of corruption it invariably stays on that path. Essentially, and in contrast to the other two theories, it states that history does matter. What this approach means to policymakers is that a “top down” approach to internal controls, one that only focuses on hard and monitoring controls, is unlikely to be successful in creating an organisation that maintains a low level of corruption. Here the focus is not just on hard and monitoring controls, but also on the soft controls – how an organisation needs to be set up with a clean, active board of directors who set the right tone at the top from day one.

Path dependency could be observed in both funds. The influence of the western bank that built up the internal control in Fund A could be clearly seen from the way that its organisational culture and policies and procedures were transferred to Fund A and still exist now, more than 30 years after the fund was established. Such influence was vital in starting the fund off on the right foot; corruption was not tolerated from the start, leading to the isolation of any corrupt officials who did not adhere to the same values as their colleagues. These practices were then greatly helped by rigid checks and balances that were implemented to establish the correct procedures for lending the fund’s money and recruiting officials on merit. The same could be said for Fund B, where experts from a developing country were assigned to set-up the fund’s internal control. Many of these experts were widely perceived to have poor ethical standards and competency, leading to continued lower levels of institutional integrity as well as weak internal anti-corruption monitoring mechanisms. This would tend to support hypothesis *H6: an effective internal control leads to a lower perceived level of corruption when it was established appropriately.*

Although historical institutionalism seemed to provide a powerful explanation for different levels of corruption, this theory was criticised for failing to acknowledge that an institution can change its levels of corruption, as history is all that matters. If this were the case, there would be little that policymakers could do to control corruption in government organisations. It is on this point that the other two theories can attempt to provide answers to policymakers to overcome this theory’s perceived weakness.

THE NEED FOR THEORETICAL TRIANGULATION IN DESIGNING ANTI-CORRUPTION MEASURES

As can be seen throughout this paper, every corruption theory provides different, but still valid, explanations of how internal control impacts corruption.

Agency analysis focuses on the micro level, i.e. on corruption committed by an individual. Rational choice neo-institutionalism analysis is at the macro or group level and focuses on how the corruption equilibrium, or the extent of corruption within an institution, can affect the decisions of all individuals working within it.

This therefore explains why theoretical triangulation is necessary. The three theories are, on their own, somewhat incomplete. Agency theory focuses on why an individual acts in the way he or she does, but ignores the institutional context – i.e. how colleagues and management can affect the way that an individual acts (and how the same individual might act in a different

context). Rational choice neo-institutionalism looks at the organisational context and how this might affect an individual's choices, but it cannot provide a solid explanation of why two seemingly similar institutions can have, at the macro level, such different levels of corruption in the first place. Historical choice theory can certainly show how such organisations can be set on such differing paths, but without looking at how individuals can be incentivised to act honestly, it cannot offer practical solutions to policy makers as to how to reduce corruption levels in institutions. This supports hypothesis *H7: the effectiveness of internal control in tackling corruption is better understood with theoretical triangulation.*

CONTRIBUTION TO THE LITERATURE

This research has distinctively contributed to the knowledge in different ways. As a start, it has contributed to the structure and agency debate in the corruption literature (e.g. Persson, Rothstein and Teorell, 2013; Rose-Ackermann, 2010) by showing how bureaucrats' behaviour is shaped by both actors' calculations and the corruption equilibrium or the extent of corruption. Through in-depth investigation of two case studies, the study has demonstrated how the combination of both theories could offer a better understanding of bureaucrats' behaviour and lead to better anti-corruption strategies that manipulate actors' behaviour to make them less corruptible. The study also showed support for emerging research in corruption theories (e.g. Hellmann, 2015) that argued that neo-historical institutionalism, with its power of path dependency, could explain the persistent levels of corruption in developing countries.

With this in mind, the following table offers a brief comparison between the corruption literature and the findings of this research.

Figure (4): The impact of internal control on corruption

#	Factors	Impact on corruption as in the literature	References ⁴	Impact on corruption as found in this study	Evidence
1	Institutional integrity vs. institutional incentives	Mixed, as some research argued that institutional incentives are more important than institutional integrity, and vice versa	(McCusker, 2006; Persson et al., 2013; Rose-Ackermann, 2010)	Both matter	They interact with each other, but institutional integrity is more important as it provides the context in which institutional incentives operate
2	The demand of corruption vs. the supply of corruption	Mixed, but more research is in support of tackling the demand of corruption by imposing rigid policies and procedural manuals, and then enforcing these manuals by periodic internal and external auditing	(Neu, Everett, & Rahaman, 2015; Sikka & Lehman, 2015)	Controlling the demand of corruption is more feasible and could contribute to lower the supply of corruption	By comparing two government institutions within the same market of corruption, the research showed how Fund A was able to limit corruption by implementing rigid policies and procedures and empowering internal auditors
3	Decentralised management	Mixed	(Birney, 2014; Hanna, Bishop, Nadel, Scheffler, & Durlacher, 2011)	High	The vast majority of corruption cases were within Fund B's branches, leading to freezing the authority to grant loans in several branches
4	Recruitment on merit	High	(Klitgaard, 2006)	High	The quality of recruitment activities contributed to different levels of corruption in both funds

⁴ The references are typical examples.

5	Training outside the developing country and secondment	High	(Noor, 2009)	High	Fund's A training and secondment with the western bank helped in establishing both the institutional integrity and institutional incentives, which in turns contributed to lower levels of corruption
6	Risk assessment	High	(Binti Zamri, Bin Wan Abdullah, & Binti Ahmad, 2015)	Low to medium	Fund A had low levels of corruption before implementing its risk assessment approach
7	Rotation policy	High, unless there a systemic corruption in a given organisation	(Abbink, 2004; Rose-Ackerman, 1999)	High	High turnover in Fund A gave the effect of a rotation policy. Some corruption cases were discovered in Fund B when officials were reallocated to different branches

In the literature, procurement is frequently perceived to be vulnerable to corruption in the public sector; yet this did not seem to be the case in both funds. This could be attributed to the small size of both funds.

CONCLUSION

The empirical evidence discussed throughout this paper supported the hypothesis that corruption corresponds to the deficiency of internal controls and therefore that effective internal control mechanisms, in accordance with the COSO internal control framework, are the cornerstone of any institutional anti-corruption initiative.

One lesson that could be learned is that if an organisation builds its internal control mechanism based on hard controls only, where every actor is perceived to be selfish/self-interested, it is less likely that it will be completely successful in reducing corruption than if it bases internal control mechanisms around soft controls – as well as hard and monitoring controls – that establish a culture where corruption is not condoned.

To be more precise, in Fund B the internal control design seemed to be guided by the agency theory, which neglects the soft element of internal control, including tone at the top, training, etc. In contrast, in Fund A, internal control design was guided by rational choice neo-institutionalism: both soft and hard controls were considered, meaning that even where there are opportunities for corruption, the instinct of most of the staff would be not to take that opportunity, but act in a more ethical manner than agency theory might predict. To put this differently, the power of expectation would play a major role in raising the costs of corruption as many officials expect their colleagues to act ethically, just as they do. Such an expectation would reduce the opportunity for collusion, which is often recognised as the main limitation of COSO internal control framework.

STUDY LIMITATIONS

Internal control has its own inherent limitations. As illustrated by the COSO internal control framework (2013), collusion (especially at the senior management level) and human misunderstanding or misjudgement could lower the usefulness of internal control.

Another weakness of internal control is the ignorance of supply of corruption as this framework was designed to eradicate corruption among public officials rather than corrupters (people who offer bribes). However, risk assessment could help in reducing the supply of

corruption through various channels, such as requiring officials to report the corrupter to law enforcement.

The last, but not least, weakness of internal control as an anticorruption mechanism is that it is more focused on tackling petty corruption. External factors such as corrupt political leaders can limit the ability of internal control and internal auditor to detect corruption in the public sector (Neu, Everett and Rahaman, 2013; Neu et al., 2015).

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