Do controls improve performance?

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1 Costs and benefits of controls

In an economic environment, controls and audits are important components of the management process. On the one hand, they constitute an important measure to avoid fraud and misuse of funds; on the other hand, they should follow activities in order to be able to assess the results and initiate learning cycles that are prerequisites for improvements. Speaking in economic models, audits take place in relations of accountability: one party referred to as the ‘agent’, is required to give an account of his actions to another party referred to as the ‘principal’. Principals are distant from the actions of agents and therefore unable to observe and verify them personally. The solution to the principal’s information problem is provided by audit activities carried out by the principal in order to inhibit value-reducing actions by agents. These audits will be undertaken up to the point where their marginal benefits equal their marginal costs. In other words, audits produce costs that have to be countervailed against earnings, outcomes or other forms of positive, value-creating effects of these control procedures.

Nowadays, this simple economic principle often appears not to work. In the public sector, state audit bodies are rapidly growing and reforms like New Public Management provide for a wider range of control measures not only to check the legality but also the performance (effectiveness, efficiency and adequateness) of public activities. Parallel to the reforms in the public sector, the private sector has also undergone increased regulation, starting with the Sarbanes-Oxley Act that was implemented by President Bush in 2002. Companies have to comply with additional internal and external control measures and fulfil stricter regulations in the field of financial reporting. These provisions aim to rebuild the stakeholders’ trust in corporate figures yet also result in a huge amount of control costs and additional workload. At a conference of the Swiss-American Chamber of Commerce in 2005, the Group General Counsel of UBS, for instance, reported that around 10% of the company’s workforce, some 5,800 employees, were involved in the internal certification process. The legal counsel of Rieter put the additional costs for the engineering group at approximately USD 20 million, in addition to a doubling of the auditing costs.[1]

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[1] Schenker-Wicki, A. (2006): Accountability: Berichten wir uns zu Tode? – Auf dem Weg in die Audit Society, in: Hermann Hill (Hrsg.): Wissenschaftliche Tagung: Die Zukunft des öffentlichen Sektors, Nomos-Verlag, Baden-Baden.

These private and public sector reforms can be seen as a development towards an 'audit society', i.e. a society in which more and more is being observed, quantified and verified, but in which increasingly less action is being taken.[2] Sociologists see this increasing penetration of quantifications as a substitute for a lack of trust and as a process of depersonalisation.[3] As numbers are frequently seen as more objective and more reliable than people, organisations can successfully withstand external legitimisation pressure, at least for the short term.
The lack of trust and the need for assurance leads to growing formalised accountability and constant checking and verification. At a certain point, a very small increase in assurance or reduction of risk by further controlling activities shows a very low marginal benefit and we can speak of 'over-auditing'. This is also confirmed by the analyses of Power who discovered that all social actions are based on the three pillars of trust, risk and control (accountability). Just as there is no life without risk, there will also be no society without control. According to Power, only the inspection styles and the manner and way in which risks are perceived and experienced change.[4] If the risk perception increases in a society and if this is also coupled with dwindling trust, the control activities have to increase in this society to achieve a new balance. This is a phenomenon that can be observed more and more frequently, particularly in the industrialised world, and thus we can already speak of an 'audit society'.[5]

There are various possibilities to escape this impending 'audit society', discussed in more detail in the next section. In this context, the development of 'trust' plays an extremely important role, based on the hypothesis that trust and reliability will develop in future into an important competitive advantage for an economy.

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Source: Power (1997)

2 Ways out of the 'audit society'

Ways out of the audit society first entail the establishment of trust and then the reduction of transaction costs by implementing intelligent organisational structures and processes:

- **Establishment of trust in an institutional context:** Trust has to do with the availability of information with respect to a business partner on the one side and with

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[2] Power, M. (1997): The Audit Society: Rituals of Verification, Oxford University Press, Oxford, p. 147.

[3] Porter, Th. (1995): Trust in Numbers: The Pursuit of Objectivity in Science and Public Life, Princeton University Press, Princeton, p. 11 ff.

[4] Power, M. (1997): The Audit Society: Rituals of Verification, Oxford University Press, Oxford, p. 138

[5] Power, M. (1997): Audit Society: Rituals of Verification, Oxford University Press, Oxford, p. 66.

the sanction system on the other side. The more positive information I have about a potential business partner and the more confident I am that my potential partner will be punished if he or she deceives me, the smaller the risk of my being deceived. Summed up in brief, this means that the more information we share, the easier it will be to establish a joint project, and the better the sanction system, the less opportunistic behaviour there will be. The information, however, concerns not only explicit information that can be called up from databases but also implicit knowledge, i.e. so-called behavioural information, in other words, information on how a business partner has behaved or behaves in particular situations.[6]

- **Reduction of transaction costs involves a reduction of interfaces and a clear allocation of responsibilities:** The simpler the design of management processes and the clearer the allocation of responsibilities is, the fewer the possibilities and risk of delinquency and the fewer auditing activities that are required. If different audit bodies are involved in the audit activities, the transaction costs can be reduced by standardisation and mutual recognition of the checks and audits, leading on the one hand to comparability of the data and on the other hand facilitating meta-evaluations. At the same time, the audit process benefits from an increase in efficiency.

3 Implications for the EU

Member States are in charge of the implementation of the majority of the EU budget (about 80%), but it is the European Commission that bears ultimate responsibility for implementation and hence, also for control measures within the Member States. The fact that the Member States are free to organise the controls in the way that each considers best, leads to a heterogeneous quality of Member States' control standards. Unfortunately, the difference in control standards is not negligible but so great that the Court of Auditors in its annual statement of assurance (DAS) has been complaining for more than 10 years that the reliability of the accounts, commitments and own resources indicated that it had no reasonable assurance for payments under all parts of the general budget of the European Union apart from administrative expenditure.[7] This situation that is not accountable from a material and political perspective forced the Commission to submit a proposal to the European Parliament that a new internal control system be set up that checks the use of funds in the individual states according to uniform control standards. Although the Commission's efforts to ensure reliability with its own internal control system are

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[6] Guinnane, T. W. (2005): Trust: A Concept Too Many, Central Discussion Paper No. 907, Economic Growth Center, Yale University, Newhaven.

[7] Commission of the European Communities (2006): Commission Action Plan towards an Integrated Internal Control Framework, Communication from the Commission to the Council, the European Parliament and the European Court of Auditors, Brussels.

understandable, the risk of over-auditing cannot be ignored.[8] If we assume that the Member States have their own internal control system for their matching funds and that all the funds are audited in parallel by the external auditors of the Member States and in addition by the European Court of Auditors, it would probably be less costly to make more intensive use of the existing structures and to forego the development and expansion of a fourth control level. Specifically, this would mean that no more controls are introduced but that the performance of the existing control system is increased instead. For it is known from economics that more controls do not automatically result in a reduction of the delinquency and thus in an increase in performance.

To increase the performance of the existing control system, the focus could be on the following activities:

Establishment of trust: Without trust there is no efficient control system because the control effort becomes immeasurable. But how can trust be established in the context of European accounting and auditing? From theory we know that, for the establishment of trust, qualified information must be made available on the one hand and on the other a **system of sanctions** must be in place that rigorously punishes fraud. This means that not only investments with regard to qualified information need to be made – these will be described in the next section - but that the European Parliament also needs to deal with an easy-to-manage system of sanctions through legislation. For there can only be a sustainable reduction in the control effort if improper behaviour is no longer punished as a peccadillo but threatened with sanctions that act as a deterrent to the extent that they achieve a change in behaviour.

Reduction of the transaction costs (interface costs such as information and control costs): The special interlocking of competences and obligations of the EU and Member States in the implementation and control of the EU budget increases the transaction costs substantially. In particular the Agricultural Policy, accounting for approximately 40% of the EU budget and therefore one of the areas with the highest expenditure, is controlled by extremely complex rules and regulations and is consequently particularly susceptible to fraud. To reduce transaction costs, the following changes need to be initialised:

- A rigorous simplification of the subsidy modalities (management process).
- A homogenisation of the obligations and competences at the supranational and national levels by making accountable the Courts of Auditors of the individual Member States that have the greatest audit know-how locally and at the same time work in the most cost-effective way.

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8 Power, M. (2004): The Risk Management of Everything, Rethinking the politics of uncertainty, Demos, Hendy Banks, London.

- Conducting all audits according to standards that have been jointly developed by the Commission and the Courts of Auditors of the Member States. The so-called qualified information gained from this is the positive result of a joint development and use of standards and increases the mutual trust. At the same time, audits that are conducted according to jointly developed standards are a prerequisite for the auditing services of the national courts of auditors being recognised by the Commission.
- Joint training of all those involved in the audit process to ensure a uniform use of standards.
- Intensive cooperation with the European Court of Auditors in the development of standards and in particular in the development of an audit matrix commensurate with the risks that foresees an audit of the individual policy fields according to international standards. These procedures will guarantee that the ‘risk of everything’ will not be taken into account (for instance the risk of reputation loss) and the control systems will be balanced with respect to cost and utility. However, even though you can construct a very broad control system in the different policy fields we know that ‘ex ante public acceptance of the possibility of failure can never control ex post public reaction to actual failure.’[9]
- An unconditional acceptance of the audit services of the national courts of auditors – in so far as these have been carried out according to common standards – by the European Court of Auditors in order to eliminate duplications. In this way, the activities of the European Court of Auditors can be restricted to audit quality standards at the national courts of auditors. In Switzerland, such a procedure has already proven its worth in individual areas because it has led to a reduction in the audit costs without any negative impact on the quality of the service.
- An increase in the audit budget of the Member States to the detriment of that of the Commission.

Summed up in brief, the following can be determined: without trust, more and more funds will have to be invested in control activities. For this reason, work needs to be done on establishing a basis of trust. In the case of the European Union, this means the development of joint audit standards by the Commission and the courts of auditors of the Member States and the establishment of easy-to-manage sanctions. The multiplication of the control activities through the introduction of an additional internal control system will make the auditing considerably more expensive and at the same time not substantially improve the

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[9] Power, M. (2004): The Risk Management of Everything, Rethinking the politics of uncertainty, Demos, Hendy Banks, London, p. 22.

auditing quality. For it is well known that a tightly knit network has more, rather than fewer, holes.

However, if the Member States refuse to make their courts of auditors available to the Commission for these tasks and if they do not wish to set up an easy-to-manage system of sanctions, the efforts of the Commission to introduce a new internal control system are understandable.