The Role and Importance of Governance for the Public Sector. Case Study for Romania

Adelina DUMITRESCU[1]

Abstract

The development and modernization of public administration under restricted budgetary resources imposes a rigorous control on the spending of public funds. In this regard the modified law of internal public audit underlines the necessity for institutional governance in the public sector. The paper starts from these changes of the Romanian internal public audit law analyzing the relationship between audit and management, and the importance of governance in the public sector.

The used method of research is based on the qualitative analysis of internal audit activities which are meant to add value to management processes in public entities. The originality of the paper consists in the qualitative study based on interpretative methods for understanding the effects of governance on management and audit.

The conclusions of the study are presenting in the paper by a governance model for the public sector and can act as starting point for future research.

Keywords: *governance, public sector, management, internal public audit.*

JEL classification: H11, H7

Introduction

We live in a complicated and complex world, where we are often faced with overwhelming realities demanding prompt decisions which must be in accordance with our plans, goals and aspirations. Mankind has structured the world in its whole complexity in organizations to give it a more approachable dimension, and to be able to ensure vision, development and sustainability (Pollitt and Bouckaert, 2011). Thus the need to manage organizations has emerged.

The major objective of the paper is setting up a model derived from corporate governance to guarantee and uphold public sector performance. Starting from literature (Paape, Scheffe & Snoep, 2003; Sarens, 2009; Clatworthy, Mellett & Peel, 2000; Anderson, Jennings, Lowe, & Reckers, 1997) and from the newly modified law of Romanian Internal Public Audit, which opens the way for public sector governance, we will identify elements within existing structures of the public administration which are suited in their organization and function for taking the different roles of the presented model. The scientific approach of the problem is an anti positive one using deductive and comparative techniques starting from the

[1] **Adelina DUMITRESCU,** National University of Political Studies and Public Administration, E-mail: dumitrescu.peculea@snspa.ro

present knowledge base, and building a governance model specific to the public sector.

The used paradigm is interpretative-constructivist by nature starting from the precepts of the institutional theory. Relationships between the different aspects of the theme will be analyzed, namely between management, internal audit and governance in the public sector with reference to the private sector.

1. Governance in public sector vs. corporate governance

The key to the success of any organization lies in the establishment of a correct set of objectives by the management, which will ensure direction, focus and hierarchy of activities. Objectives should cover the whole organization and must include improvement and development of key activities and performance governance systems.

Corporate governance, which for the private sector aims to guarantee investors good returns, can be applied to the public sector in order to ensure society that public administration acts on its behalf. These two aspects have a common ground: insurance of a performance management which acts within the boundaries of law, ethics and best practice. A first step for introducing governance to the public sector was taken by the Romanian Government when it issued a law (OUG 109/2011 published in M.O. no. 883/2011) for the introduction of corporate governance to public owned enterprises in order to increase the efficiency of such companies. As a further incentive state owned companies which are working efficiently and show good governance will be listed on the Bucharest Stock Exchanges as stated in a Symposium which was organized in February 2012 at the Romanian National Bank.

Corporate governance is defined as "the principles, rules, norms and relationships which ensure proper enterprise management to the best interest of actual and potential investors" (Feleaga, 2004 and OUG 109/2011). Business practice has formed two main types of corporate governance, European and Anglo-Saxon which are based on the conflict between shareholders and stakeholders. Some authors (Tirole, 2001) speak of shareholder value vs. stakeholder value. Shareholder value is oriented toward increasing profits and share price and is typical for the Anglo-Saxon countries with highly developed financial markets. The balance of power leans strongly to the shareholders which exert the greatest pressure of the management. On the other hand, stakeholder value is oriented towards defending the interests of all implicated parties (employees, shareholders, managers, commercial and business partners). This model is present in most European countries, except Scandinavia and Great Britain. Governance is by nature a social and political matter which implies company law, finance and financial markets, accounting and audit and also organization sociology.

In this context, the OECD states that "governance is the system by which enterprises are managed and controlled". The structure of governance defines the distribution of privileges and responsibilities for the different stakeholders like managers, shareholders and third parties, explicitly detailing decision making procedures and norms.

In addition to OUG 109/2011 regarding corporate governance for public owned enterprises, Audit Committees have been introduced by Law no. 672/2002 modified in 2012 to public entities having a budget of over 2 billion Lei (≈ 500 mil EUR). This applies to public institutions as well. This law is essential in the way that it introduces one key element of governance to the public administrations namely the Audit Committee. As stated at the beginning of the paper the aim is to approach governance from a relational perspective rather than a structural one.

Thus public administration has to concentrate on the „stakeholder – shareholder" conflict shown in figure 1, and the functional relationships to the different groups of interest. To reach our goal we must identify the stakeholders and "*shareholders*". Shareholders do not own parts of the public institutions as they do for the private sector, given fact that public institutions are not divided into shares. For purposes analogy only we will be using still the term of "shareholder". Shareholders are for us persons and organizations who given their capital intake to the budget of the public institution have great influence on the decision making processes. The main shareholder of a public entity is currently the manager of the hierarchical superior public institution.

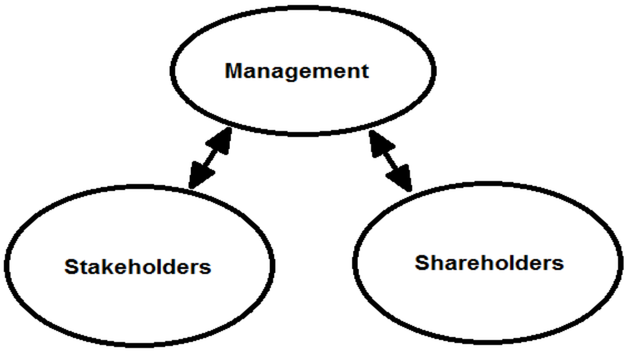

Figure 1. The relationship between shareholder-stakeholder-management

Thus the role of governance in public administration is the guaranty that the public sector fulfils its mission for the wellbeing of the community it serves (Vasile, 2009).

2. Governance relationship within public entities

2.1. Audit' s influence on management

Since contemporary society changes at a rapid pace, one of management's main challenges consists of adapting organizations to ever growing demands. Management is always situated at the border of many disciplines being regarded upon from an interdisciplinary perspective (Matei, 2006), just like internal public audit. Managing organizations has to be carried out considering all its dimensions (human, social, economical, technological etc.) (Dumitrescu, 2010). Neglecting any of these dimensions can have grave consequences for this organization.

The quality of the management is a major factor of the success of any organization and consists in the talent, ability and determination of managers to react to changes (Dijmarescu, 1995). Management is of high quality when methods and procedures applied increase the efficiency of the organization.

Having said all of the above, common opinions to guarantee a good function of management can be observed: Attention to *defining purpose and objectives*; Accent on *the rational organization of public manager's activities*; Growth of *the autonomy level and managerial flexibility*; Inclusion of *economy, efficiency and efficacy in the managerial approach*; *Performance indicators for public managers* (Androniceanu, 2004); *Focus on markets and citizens satisfaction*.

Public management should promote new standards, both theoretical and practical in which objective and responsibility, but also creativity and innovation are essential.

Internal public audit is considered to be an attribute of leadership. Being represented by the internal public auditor it must be close to management as well as management has to let itself be assisted by the internal auditor in matters that concern decisions in order to have a better control on the activity. Assistance and counselling are attributes of audit while control is and attribute and obligation of management. An Anglo-Saxon principle regarding the necessity of control states that "people do what they have to do when they are aware they will be controlled" (Zecheru and Nastase, 2005), while audit is an activity meant to ensure the functioning of the organization according to standards, laws and regulations.

Audit is a tool of the public management which must not only discover flaws in the application mechanisms of laws governing public activities, but also flaws in the laws themselves thus optimizing the hole public system which is crucial when working with public funds coming from collective taxes. Public sector activity must be carried out according to the 3 "E" principle (economy, efficiency, efficacy) (Arens and Loebbecke, 2006). Evaluations of activities according to these principles must take into account other aspects beside public utility. Activities have to be asserted in accordance with their effects on the national economy and it is the role of public audit to maximize the benefits as such.

Internal audit is not a key function of economic entities, but rather a complementary one with a management support function. Admitting that internal auditors "council" "assist" and "recommend", but **never decide** it is obvious that internal audit represents a mean for improving management control one activities thus reaching the objectives. However, internal public audit has a set of advantages over the management in assessing the activities: It has reference norms conferring it the authority to verify; Has methods and instruments to guarantee efficacy; Has independence of thought and autonomy to conceive all working hypotheses and formulate best recommendations; Does not have the constraint and obligations of a permanent activity (Renard, 2002).

Thus, internal public audit is best suited for supporting public management by giving an objective opinion on the activities within the organization. To formulate such an opinion, time and highly trained specialists are necessary.

2.2. Management responsibility

One of the main problems of public administration is accountability for the reached performance levels. This accountability lies at the political level. Society will sanction a legislation which does not keep election promises by a mistrust vote in universal elections. Next to political accountability there has to be an accountability of the management of the public sector, which at the moment does not exist in the Romanian public administration.

The problem of management accountability towards shareholders has been most elegantly solved by the private sector by introducing corporate governance. Despite the fact that successful foreign companies give an enhanced importance to value reporting, few local companies do so. It is essential that public entities understand the mechanism of value creation by using value reporting next to the general financial reporting.

Through a thorough analysis many important issues such as reducing the risk of in efficient investments can be solved. Therefore it is necessary: to obtain information based on nonfinancial indicators; to publish a list of major risks and explained the management system. In the relationship of shareholders and stakeholders as well, internal public audit plays a significant role because it is the only one able to guarantee that the entity is working economically, efficiently and efficacy. Audit reports express objective and pertinent opinions regarding the processes within the entity. The users of the audit report receive information which they use in further evaluation and decisions.

However, management responsibility is not only a financial matter, but also regards human, social, political and even technological aspects. It is worth noting that the bad management causation story for the documented correlation is hardly a ringing endorsement of entrenching provisions and the managers adopting them (Bebchuk *et al.*, 2009).

3. A posible governance model for the public sector

The first problem of governance in the public sector refers to the possibility of its existence. Speaking from an organizational point of view, his public sector consists of entities (official organisms and public institutions) which basically have the same interactions with the environment as private entities or NGOs. There are two main differences: the private sector is profit driven will the public sector isn't; the main stakeholder of private organizations is the shareholder and for the public sector the main stakeholder is society.

However, between the two types of organization show some resemblances: both have social and economic relationships with their environment; both have management structures; both are dependent on generating positive cash-flows for a normal operation; both have control structures for ensuring correct functioning and conformity with the legal framework.

Taking the above into consideration we may conclude that it is possible to apply a governance model to the public sector. The main issue is whether this model should be based on the governance models accepted by the Romanian commercial law, namely the unitary and the dualist model. Since public institutions depend on the hierarchy of state while private organizations are independent it is safe to assume that the implementation of such governance models would be close to impossible. Also managerial accountability in the public sector is concentrated by law to only one person and cannot be divided within a council, committee or a directorate. This person is accountable for the budget allocation and spending within the institution he manages and also for those institutions that hierarchy depends on him.

A functional governance model for the public sector must not significantly alter the existing organizational structures, but redefine the relationships with the environment in order to induce responsibility and accountability for the way in which it acts. Also, such a model should introduce or enforce within the public administration notions such as (Prado-Lorenzo *et al.*, 2009): Social responsibility; Performance; Financial accountability in spending public funds.

Thus, a governance model (*shown in figure 2*) can be set up based on the development on the relationships of public institutions with those organization and networks that have an influence. There are three groups of interests on the public sector: stakeholders, shareholders (as defined at the beginning of the paper) and other organizations.

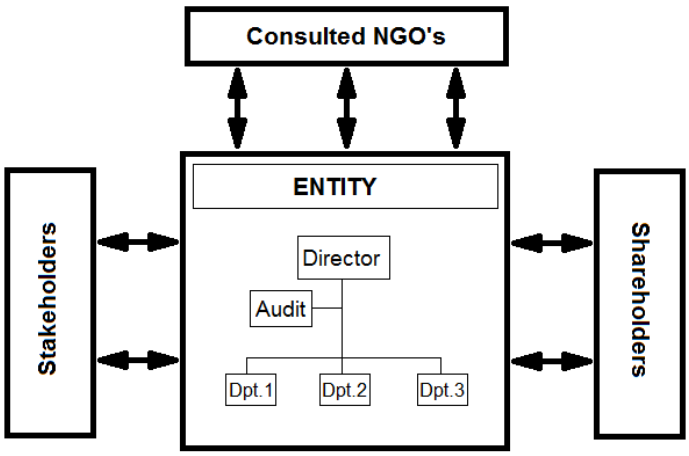

Figure 2. Detailed governance model for the public sector

Stakeholders are organizations or persons which can act for the public sector as markets act for private entities. By acting we understand every action through which the entity builds or strengthens economic and social relationships with its environment. For companies stakeholders are clients, suppliers, state institutions, financial institutions, syndicates, shareholders and others. For the public sector stakeholders are civil society, businesses and other related public institutions.

However, any stakeholder plays for the public institution this role in two different ways. On one hand, every entity is a tax payer, thus indirectly contributing to the budget of public institution. Also, the same entity can become at any moment the beneficiary of a public good or service giving it the right to ask for accountability (Harlow, 2002) regarding the way public funds is being spent.

Accountability of public administration is recognized when citizen of any democratic system acknowledge their right to directly or indirectly monitor and question administrative activities. The indirect questioning can be carried out through the People's Advocated Institution, any Parliamentary committee or audit group (Iancu, 2010).

Other organizations with which public institutions are relationships are NGOs. This plays a most important role in the conflict between shareholders, stakeholder and the institution. They can act as buffers between the different groups of interest by identifying development possibilities through social audit and also function as consultancy organisms for public institution.

4. Disscution and conclusions

Although theory justly includes shareholders within the ranks of stakeholders we will strictly differentiate between these two categories, because: public institution activity is socially responsible by nature; the purpose of public institutions is not gaining profits; shareholders cannot receive dividends at the end of the fiscal year; despite the fact that they do not receive dividends or any other form of financial compensation, shareholders are financial risk carriers.

An efficient governance model for the public administration must support and complete the modernization process of the public administration which started with the joining process to EU structures. The role of governance in the public administration is ensuring the fulfilment of its mission to the benefit of the community and the guarantee of best practices and social responsible actions. Modern management tendencies are oriented towards quality insurance of the organization activities and constant process improvement (Freeman and Shoulders 1999). This improvement process is based on asserting a knowledge base and measuring and documenting all events that take place within the organization.

The scientific approach is a starting point for further studies on public sector governance, future assessments will be depending on how public administration understands to make changes to current leadership and control structures.

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