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Corporate Governance and public sector entities

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Abstract

Public entities' Corporate Governance is a concept that is gaining more and more field both in specialized literature and in practice. The public bodies' Corporate Governance as leadership and control method involves a set of clear rules and principles (integrity, honesty / sincerity, transparency and responsibility), clear risk management and control mechanisms, elements needed to achieve the purpose of public entities, which is satisfying public needs. Is Corporate Governance necessary within public entities? Can it contribute to the efficient use of public funds, the decrease of expenses or budget deficits, the elimination of corruption and the increase in performance in public entities? The purpose of the paper is to achieve an academic analysis of the development process of the Corporate Governance concept in public entities and of how it is an efficient governance form. The research methodology was based on consulting specialized literature, respectively using the historical method for pointing out the milestones in the Corporate Governance concept evolution and the comparative method for the analysis of advantages and disadvantages of corporate governance in the private sector and how this model can be implemented in the public sector.

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Keywords: Corporate Governance, public sector, public entities

1. Introduction

The present paper proposes an analysis of the Corporate Governance (CG) concept of public entities, as a method for management and control.

What is CG? Is there a unanimously accepted definition of this concept?

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If the term “governance” refers to “leading” / “managing”, the “corporative governance” then refers to something extra, respectively the leading / managing of an organization (Ghita, 2008: 13). Therefore, we can affirm that this concept – corporate governance – is the integral management of an organization in its entirety, by accepting all internal components, which work together, but which will eventually be integrated to the leadership and implementation of risk management within the organization, as well as the financial management and internal control management system, including internal audit. (Ghita, 2008: 13)

The purpose of this research is to achieve both a theoretical analysis of the CG concept as management and control form of public entities, and an empirical analysis of the CG models of public entities in states that have implemented this governance model.

In the first part of the paper, we will briefly describe the history of CG, where we will relate the key moments of the appearance and development of CG and we will define the concept. In the second part, we will analyze and highlight the principles and characteristics of CG in the private sector (the American model), followed by the third part, where we will analyze the characteristics of CG in public entities, as implemented in UK. The last part of the paper will be reserved for conclusions, as they flow from the relevant information presented thus far.

1.1. The Appearance of the Corporate Governance concept

The appearance of the Corporate Governance term at international level took place in the context of repeated serious fraud and financial abuse in countries with developed capital economies (USA, UK, Italy).

According to specialized literature (Ghita, Albu et all. 2013; Ionescu, 2010), the first time CG was mentioned was in the 70s, following the Watergate scandal, where American private companies were discovered to have been involved in politics, respectively through illegal financing of political parties in the USA.

Later on, during the 80s and 90s, several companies from the United Kingdom, which were listed in the stock exchange became bankrupt within a very short period of time (Ghita, 2008): Guinness, 1986, Polly Peck International – 1989, Maxwell – 1991, The International Trade and Credit Bank – 1991, Barings Futures – 1995, etc.

It was not only the private sector that faced financial failure and fraud, but also the public sector. Some illustrative examples are: the Metropolitan Police case of 1995, where the deputy manager of finance of the Metropolitan Police, Anthony Williams, stole over £5 million during the period 1986-1994, as well as the Inland Revenue case of 1997, where the Group Chief of the Inland Revenue Special Office No 2, Michael Allock, who was investigating foreign business people’s taxes from 1987 to 1992 was accused and found guilty of fraud, receipt of bribery, spending family vacations paid by certain business people, as well as using the services of a prostitute in exchange for information on certain cases.

Also illustrative is the case of the European Commission – 1999/2002 (Ghita, 2008), where 15 members of the Commission resigned following fraud and inadequate financial management identified by 5 independent experts nominated by the European Parliament.

As a response to these financial failures and frauds, national governments and different competent bodies manifested concern and initiated changes, by toughening the CG laws and introducing sanctions meant to determine companies to adopt ethical and transparent policies. These concerns and changes were translated into CG codes.

At the present moment, the great majority of developed and developing countries have a Corporate Governance Code, issued by different ruling bodies (according to www.ecgi.org, at global level there are 409 developed corporate governance codes). Among them, the best knows are Actual Sarbanes-Oxley, in the USA, developed as response to the failures and scandals that took place in the USA, the Cadbury Code and the updating of the United Kingdom code, as a reaction to the failures of companies listed in the British Stock Exchange.

Therefore, in the context of the 1970-1990 scandals, the mission of CG was that of balancing and equal division of power between shareholders, administrators and executive management, with the purpose of preventing the appearance of new frauds and financial abuse, and especially of regaining the society’s trust in the business environment.

1.2. Defining the CG concept

The first author who manifested interest in researching the causes of the financial failures and who conceptualized CG was Adrian Cadbury, who, in 1992, as president of the Committee for Corporate Governance Financial Aspects in Great Britain, developed and published the Cadbury Code.

The Cadbury Report defined CG as "the system by which companies are managed and controlled".

Among the international competent bodies that took interest in researching the causes of financial failures and prevention of such events in the future, we can also count the World Bank and the Organization for Economic Cooperation and Development (OECD).

Upon the World Bank's recommendation, the OECD elaborated the 1999 OECD Report, where the principles of CG were set, the only set of CG principles to date which is recognized at international level and represents one of the 12 foundational pillars of international financial stability.

According to the statement of the OECD Report on Corporate Governance in Romania – 2001, CG represents (OECD, 2001):

- A set of relationships between the management of the company, the administration board, its shareholders and some stakeholder groups;
- The structure by which company objectives, means for achievement and performance monitoring indicators are set;
- The stimulation system given the Administration Board for the monitoring of objectives, which are in the company's and shareholders' interest and for facilitating monitoring, encouraging companies to use resources more efficiently.

According to authors Andrei Shleifer and Robert Vishny, in the 1996: „Corporate Governance refers to the way a company's funding providers ensure that they will receive the due benefits of their investment".

According to the Australian National Audit Office (ANAO), 2003, "Corporate Governance refers to the processes by which organizations are managed, controlled and owned. This refers to authority, responsibility, administration, management, guidance and control within the organization".

The United Kingdom Corporate Governance Code (2012) suggests that corporate governance refers to "what a company's Administration Board does and the way it sets the company values, and it is different from day-to-day operational management by full-time managers".

According to Marcel Ghita, is "an attempt to implement risk analysis, verification, evaluation, control systems that contribute to an efficient management for their functioning. (…) this has to be approached alongside risk management for the entire organization (ERM) and with the evolution of the financial management and internal control system (MFC)"

From all these approaches, the meaning of Corporate Governance is that of "*the way in which an organization (public or private) is lead and controlled, with the purpose of getting performance / accomplishing its responsibilities successfully and bringing added value, as well as using financial, human, material and informational resources efficiently, while respecting the rights and obligations of all involved parties (shareholders / investors, Administration Board, managers, employees, state, suppliers, clients and other people with a direct interest).*"

1.3. Corporate Governance Principles

The 1992 Cadbury Report set 3 foundational principles that companies listed in the stock exchange have to observe: openness, integrity and accountability.

The 3 principle set by the Cadbury Report (paragraphs 3.1-3.2) are explained as follows:

1. Openness of the companies, in the limits set by their competitive position, is the foundational element for the level of trust which needs to exist between the business and all those who have an interest in its success. An open approach towards information dissemination contributes to the efficient functioning of market

economy, determining the Boards of directors to take more efficient measures and allowing shareholders and other stakeholders to better check their companies

2. Integrity – it means both direct practice and completeness. What is required of financial reporting is that it should be honest and that it should present a balanced picture of the state of the company's affairs. The integrity of reports depends on the integrity of those who prepare and present them.
3. Accountability – The Boards of directors are accountable to their shareholders and both have to play their part in making that accountability effective. Boards of directors need to do so through the quality of the information which they provide to shareholders, and shareholders through their willingness to exercise their responsibilities as owners.

Starting from the principles set by the Cadbury Report, which represented the starting point in the field of CG laws and principles and from other CG codes elaborated afterwards (e.g. Rutterman Report, Greenbury Report, Hampel Report, the Combined Report), which supported and completed the Cadbury Report, in 1999, the OECD developed the key principles of corporate governance, which set the foundation of CG functioning and which are (OECD, 1999):

1. Ensuring an adequate framework for the effective implementation of sound corporate leadership – the CG framework should promote transparency and efficiency of markets, agreement with rules and laws, as well as segregation of responsibilities of different management, regulations and authorities;
2. The Shareholders' rights and key aspects related to ownership rights – the framework of CG should protect and facilitates the shareholders' rights;
3. Equal treatment of all shareholders – the CG framework should ensure equal treatment of all shareholders, including minorities and foreign shareholders. All shareholders should have the opportunity to get actual compensation if their rights are disrespected;
4. The stakeholders' role in corporate governance – the CG framework should acknowledge the rights of stakeholders set by law or by other approved commitments and should encourage cooperation between organizations and stakeholders for value and job creation and for supporting financially sound enterprises;
5. Information and transparency – the CG framework should ensure a credible and prompt information issuance / transmittal, referring to all material issues involving the corporation, including financial situation, performance, ownership and management of the company
6. The Board of Directors responsibilities – the framework for CG should ensure the strategic guidance of the company, effective monitoring of the management by the Board of directors, as well as the accountability of the Board in front of shareholders and the company.

1.4. Characteristics of GC

According to specialized literature, there are two approaches regarding the CG involved parties, as follows: part of the authors consider as direct stakeholders, who are directly involved and affected by the performance or failure of the company only the shareholders / investors, while the others consider that its progress or failure can be of interest and can directly affect also other stakeholders, such as managers, suppliers, state, employees, clients and other persons with interests within a company.

But when we speak of the characteristics of an efficient governance system, all authors refer to the optimization of relations between management, directors, investors and all other stakeholders. (Durica et. all: 2)

Among the important traits of CG we can mention: the existence of CG rules – CG code, the existence of a risk management system, the internal audit, the Audit Boards and the external audit.

In specialized literature, 3 universal models of corporate governance are known: the American model, which is spread in the USA and Great Britain, the German model and the Japanese model.

The American model is characterized by the domination of independent persons and individual shareholders, who are not connected by the corporation through business relationships – the so-called "outsiders", and the dispersion of social capital to a multitude of shareholders, who are mainly interested in the gains, without getting involved in the corporation's business.

The German model took a series of traits of the American model throughout time, but kept its specifics. The dominant trait of the German model is the high concentration of capital, manifested in the fact that majority shareholders are connected to the corporation by mutual interests and take active part in the management and control of the enterprise – so-called “insiders”.

The Japanese model or the governance by intervention is very similar to the German model, as investors, represented mainly by bank institutions, are connected to the corporation and get involved in its management and control.

Seeing its extended use, for the present study we will provide a detailed analysis of the American model (used in USA and the UK).

The characteristic elements of the American corporate governance model (Ghita, 2008) are:

- The shareholders-directors-managers relations;
- The dimensions of conformity-performance-accountability;
- The corporate legislation and regulation – final accounts – ethical standards;
- The external audit;
- The Auditing Committee;
- The internal audit;
- Performance, commitment and abilities.

The Watergate deal in the ‘70s, as well as the financial failures / bankruptcies that took place in the ‘80s in the USA did not remain without effects. In 1990, a commission was set, made of “the key accounting, financial and audit organisms, to develop a practice code for corporative management”, and 2 years later (1992), another commission – “the Treadway Commission, developed a document which represents a model for efficient corporate governance, titled “Internal Control – Integrated Framework”, also known by the COSO acronym” (Ghita, 2008)

According to Marcel Ghita (2008), the COSO model has a hierarchical structure, made up of five components:

Control environment – at the inferior level of the model, this environment is that on which an organization sets standards and objectives for its control systems, which include: integrity, ethical values, management competence and superior management roles.

Risk assessment – is, at present, a *fundamental part of the new definition of internal audit* and consists of the identification and management of risks and development of strategies to reduce their impact.

Control activities – represent the policies and procedures that ensure that measures are taken to make internal control systems more efficient and which need to operate on all organization levels.

Information and communication – support the organization to work efficiently, in the context of adequate management. Information can come from internal sources (accounting information and operational reports) or from external sources (government directives, laws and analyses of competitiveness) and the operative communication ensures a more efficient management.

Monitoring – ensures the periodic revision of internal control systems and their adequate management, so as not to lose their ability to correctly influence the organization’s operations.

Taking into consideration that UK does not have a written constitution, which is why it cannot use the tools for law issuance, unless exceptions are made, corporate governance in UK was developed in a series of best practice codes in the field. This did not become an obstacle in adopting and observing these codes by companies. Moreover, they were adopted and openly accepted by other countries, following the inefficiency and lack in their national regulations.

The most important Corporate Governance Codes developed and implemented in the UK were: the Cadbury Code, the Greenbury Code, the Hampel Code and the Combined Code.

In the next paragraph, we will present the elements of CG (Ghita, 2008: 65 – 91):

A. Relations between shareholders-directors – process managers

Relations within the American model function on the basis of the agent theory, respectively that owners / shareholders / representatives nominate directors, who supervise the organizations / corporate organisms. The directors analyze the market expectations and the society’s demands and develop a strategy, so as to achieve their proposed objectives. For their achievement, the directors recruit managers, supervisors and operational staff, so as ro implement the strategy.

When directors and employed staff are completely competent, professional and honest, the corporate governance model should work efficiently..

Dimensions of conformity – performance – accountability

For the functioning of the corporate governance model, the dimensions of strategic performance and those of accountability of published accounts should be added, needing to ensure conformity to the established principles, all essential elements of the agent theory.

The Directors set the organization's objectives and based on these, develop policies and strategies in the specific fields of activity.

For all set objectives, they establish key performance indicators, which represent targets and which will be part of performance reports.

The accountability of Directors regarding the organization's results under their representations will be materialized in the reports they will provide, on the structure of the organization's final accounts and the analysis of the achievement of the performance indicators.

C. Corporate Law and Regulations – final accounts – ethical standards

The Legislative Framework which regulates the corporate field must contribute to the protection of people and groups that invested in the organization and who have direct interest in any of the services or products or any partnership arrangements. The regulation framework should also ensure a competitiveness level and inspire in adding value to the organization.

The final accounts and the annual report should include all information requested by the users and should be presented in a correct and real manner, according to the international accounting standards. Also, the final accounts should present an interface between the external world and the organization, so the interested users can receive a clear perspective on the way in which management is behaving and what its performance is, in order to avoid later unpleasant surprises.

Ethical standards set by the organizations represent a permanent concern, so as to ensure reaching set objectives, which, once developed, are disseminated to the employees, as well as people who could contribute to the definition of acceptable behavior.

Ethical standards must be the platform for all organizational activities and should be given priority in making important decisions. Also, these standards should support the human resources management system (e.g. the selection, professional training, evaluation, conflict management, etc.) and should be part of a consistent message of the management's values. All employees should be encouraged to report all current or potential risks with material effects on the company, clients or shareholders, and as response, the management should follow-up with positive action.

D. External audit

External audits are meant to verify whether the accounts of an organization correctly reflect its financial performance and which are its assets and its debts at the end of the financial year. The external audit mission is finalized with an audit report on annual accounts.

E. The audit committee

The audit committee represents a traditional element of the Board of directors and is made up of, usually, minimum three non-executive directors.

The role of the audit committee is to provide the supervision of the corporate governance process and to liaise directly to shareholders, through a separate annual report. Also, this committee must ensure that the general management is competent to implement an effective risk management and internal control system within the organization. Competent and experienced people should be part of the audit committee and ensure that they have sufficient time and resources to guide and monitor the accounting, the audit, the responsibility, ethical values and governance arrangements, without the appearance of conflicts of interests – real or probable.

F. Internal audit

The internal audit must be professional, independent and adequately provided with resources, so as to develop the actions for which it is responsible, according to the implemented standards, concentrating on risk management, control and corporate governance, to achieve a good balance between the audit activities and consulting.

The internal audit has a role of consultation and guidance of the general management with regard to the existence of a sound risk management and internal control system for the significant organizational operations.

G. Performance, commitment and abilities

Commitment and abilities are two concepts which have been added to performance, conformity and accountability.

Commitment represents the implementation of corporate governance values in the minds and hearts of all those having an interest towards the company.

Abilities refer to professional training, budget, time duration and understanding of what is needed for new commitments, such as control self-assessment tasks.

Performance, conformity, accountability, commitment and abilities represent the leadership keys in ensuring an enthusiastic response towards corporate governance.

Risk management should represent a sound risk management system in organization systems and processes that take part in the reporting system and which are normally organized in compartments in the entire organization.

Therefore, implementing the characteristic element 7 of the corporate governance – performance, commitment and abilities, involves the organization of a management system for risks, by developing risk journals, the analysis and evaluation of the internal control system, which assists in managing risks and the development of an adequate operational working procedure system.

2. Characteristics of Corporate Governance of public entities – UK Model

Considering the benefits and effects Corporate Governance has in the short, medium and long term, the corporate governance model was adopted and implemented in the public sector, as a New Public Management approach during the ’80-s and the ’90-s by countries such as New Zealand, Australia and the UK.

For this paper, we will analyze the characteristic elements of the CG model implemented in the public sector in the UK. We mention that the CG of public entities presents certain specific traits compared to the private companies corporate governance.

2.1. The appearance of Corporate Governance in the public sector in the UK

As shown in Chapter 1.1. above, not just the great private corporations were affected by financial failures and fraud, but also public entities (see the cases of the Metropolitan Police and Inland Revenue).

As such, the corporate governance of the UK public sector has been adopted as efficient method for management and control of public entities, following the scandals that centered around the behavior of certain politicians and personnel involved in the public life in the beginning of the ’90-s. The most illustrative scandal of this kind was the 1994 deal „cash for questions”, when a number of members of Parliament accepted the offer from some journalists (from the Sunday Times) or from persons with different interests (e.g. Ian Greer – business man) to ask questions in Parliament on certain themes in exchange of cash sums varying from £1000 to 2000.

Following these scandals and financial frauds of the ’90-s, in October 1994, the Prime Minister John Major established the Committee for Public Life Standards (the Nolan Commission, after the name of the Committee President), as a consultative, non-departmental, public body, under the Government, aiming at analysing the causes of the scandals and financial frauds and to identify solutions.

2.2. The Principles of Corporate Governance in the UK public sector

In May 1995, the Nolan Commission set seven key principles of public life addressed to the members of public central organizations (members of Parliament and ministries, as well as public servants), known as „the Nolan principles”: (CIPFA, 1995)

Selflessness - Holders of public office should take decisions solely in terms of the public interest. They should not do so in order to gain financial or other material benefits for themselves, their family, or their friends.

Integrity – Holders of public office should not place themselves under any financial or other obligation to outside individuals or organisations that might influence them in the performance of their official duties.

Objectivity - In carrying out public business, including making public appointments, awarding contracts, or recommending individuals for rewards and benefits, holders of public office should make choices on merit.

Accountability – Holders of public office are accountable for their decisions and actions to the public and must submit themselves to whatever scrutiny is appropriate to their office.

Sinceritate – Detinatorii de functii publice ar trebui sa fie sinceri în ceea ce priveste deciziile si actiunile pe care le întreprind. Ar trebui sa prezinte motive pentru ceea ce întreprind si sa restrictioneze informatiile numai atunci cand interesul general al publicului o cere în mod clar.

Openness – Holders of public office should be as open as possible about all the decisions and actions that they take. They should give reasons for their decisions and actions and restrict information only when the wider public interest clearly demands.

Honesty - Holders of public office have a duty to declare any private interests relating to their public duties and to take steps to resolve any conflicts arising in a way that protects the public interest.

Leadership – Holders of public office should promote and support these principles by leadership and example.

Two years later, the Committee for Public Life Standards expanded the seven principles of public life towards the staff involved / employed in the local public administration.

2.3. Characteristics of the Corporate Governance of public entities in the UK

Considering the particularities of the public sector, respectively public entities not being listed in the stock exchange and not being owned by investors / shareholders, as well as the fact that they are not exclusively oriented towards profits, the characteristics of private companies' corporate governance do not entirely reflect within the corporate governance of public entities.

In the context of the critique brought to the Cadbury Code (which was criticized in the specialized literature because it referred solely to the private sector, and not to the public sector), starting from the three fundamental principles of corporate governance identified by the Cadbury Report, in July 1995, the Chartered Institute for Public Finance and Accounting (CIPFA) developed the first corporate governance framework for the public sector, containing a common set of principles and standards for management and control of public organizations.

The corporate governance framework for the public sector, developed by the CIPFA approaches 3 key areas:

The first key area – *organizational processes and structures* – refers several aspects regarding:

- Responsibility towards the law;
- Responsibility for public money;
- Communication with stakeholders;
- Roles and responsibilities for:
    - Balance between power and authority
    - Council
    - President
    - Non-executive members of the Board of directors
    - Executive management.

The second area of the corporate governance framework – *controls and financial reporting* – consists of the following components:

- Annual reporting,
- Internal controls:
    - Risk management
    - Internal audit
- Audit committees,
- External audits.

The last area of the corporate governance framework – *behavioural standards of directors* –refers to:

- Leadership / management
- Behavioural codes

o Selflessness, Objectivity and Honesty

2.4. The Corporate Governance of local public authorities in the UK

The Corporate Governance of public entities in the UK did not stop at central (government) level. It also extended towards the local public authorities. Therefore, following the adoption of the 2000 Local Government Act by the Parliament of Great Britain, corroborated with the Corporate Government in Local Government – A Keystone for Community Governance, developed by the CIPFA in 2001 (and revised in 2004 and 2007), the local public authorities corporate governance expanded considerably.

Following the analysis developed within the Corporate Governance in Local Government – A Keystone for Community Governance, the following specific elements of public entities CG were established (CIPFA, 2006):

- how the Framework fits in with other local government initiatives and guidance
- examples of good practice
- examples of the types of systems, processes and documentary evidence that might be cited by an authority to demonstrate compliance with best practice (such as the constitution, standing orders and job descriptions)
- the principles underlying who should be nominated by the authority to take responsibility for the review on its behalf and the scope given
- signposts to other useful tools and sources of guidance available to local authorities for self-assessment purposes
- questions for internal use to help authorities in their approach.

According to thePublic Administration Good Governance Framework developed by the CIPFA in 2007, following the publication of the 2001 Corporate Governance in Local Government, the following changes occurred at local public authorities level:

- in England and Wales, the new political structures and the new ethical code reprezented a better performance and local authorities control;
- the members of local authorities are directly and solely responsible of the local community, which makes their influence to be essential in the building and sustainable development of the community;
- the authorities are subjected to external control through the external audit of the financial situations and through the Comprehensive Performance Assessments – CPA in England;
- the authorities must publish their financial situations and are encouraged to prepapre an annual report;
- many authorities are subjected to national standards and objectives, such as the education level;
- their budgets are subjected to Government revision and are significantly influenced by it, through the power of intervention and modification of their budgets;
- both the members of the authorities (politically elected), and the public servants, are subjected to the behavioural codes;
- moreover, in the case of inadequate administration, the damaged person can contest or appeal either the local council, or directly the parliamentary advocate.

3. Conclusions

Public authorities' corporate governance, through the delivery of public services, aims at satisfying the citizens' needs and the public benefit, respectively.

At first glance, the two models appear totally different, but upon deeper analysis of the two criteria mentioned above, the conclusions are: 1.Increasing the profit for shareholders – this does not exclude the client (citizen) satisfaction; on the contrary, the big corporations and multinational companies guide their strategies in this precise direction. Through the client satisfaction increase, the company income increases, therefore the general objective of „obtaining profit growth for shareholders" in reached. The only difference is that the products and / or services supplied are not addressed to satisfying a general need or interest, but a very concrete one. 2.Satisfying the needs of the citizens / public benefit – if we start from the hypothesis that citizens are the shareholders of public services, considering that they finance these services through taxes and dues to the State budget to receive prompt and quality public services, then we can consider that the public organizations' goal is to obtain growth in citizen profit.

Therefore, the model of corporate governance in the private sector does not differ greatly from the public sector corporate governance.

In the same way that the corporate governance in the private sector in the early '90s aimed at improving corporate management, increasing responsibility and transparency, for regaining the trust of the shareholders, the public authorities corporate governance aims at developing and improving management and control mechanisms, taking and fulfilling responsibilities of the public personalities (politicians, public servants, etc.), for regaining the trust of the citizens.

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