# "Governance and financial health risk in an emerging economy's public sector"



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| **ARTICLE INFO** | Shewangu Dzomira (2017). Governance and financial health risk in an emerging economy's public sector. *Public and Municipal Finance*, *6*(1), 83-87. doi:10.21511/pmf.06(1).2017.09 |
| **DOI** | http://dx.doi.org/10.21511/pmf.06(1).2017.09 |
| **RELEASED ON** | Wednesday, 05 April 2017 |
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| **JOURNAL** | "Public and Municipal Finance" |
| **ISSN PRINT** | 2222-1867 |
| **ISSN ONLINE** | 2222-1875 |
| **PUBLISHER** | LLC "Consulting Publishing Company "Business Perspectives" |
| **FOUNDER** | LLC "Consulting Publishing Company "Business Perspectives" |

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# Governance and financial health risk in an emerging economy's public sector

## Abstract

Public sector financial health coupled with good governance is an indispensable ingredient of the growth route of any particular nation. The financial health antecedents in the public sector include under-spending of capital budgets, going concern and debt management. The study seeks out to scrutinize governance and financial health in an emerging country's public sector. The study has been directed by the two theories namely, Agency theory and Stewardship theory. Governance hassles may take place in relation with numerous principal-agent affairs as well as stewardship matters. This study is centred on an interpretative philosophy which observed evocative and emblematic content of qualitative data from 24 General Reports on The Provincial Audit Outcomes for the three periods (2012-2013; 2013-2014 and 2014-2015). The findings suggested that most of the provinces have shown a lapsed or little progress in the sufficient monitoring and oversight of the cash flow, capital expenditure and debt management processes at a number of agencies and departments. This resulted in almost all the monies payable to the provinces not collected, capital projects not appropriately managed, suppliers not paid on time, and cash shortfalls to bring on the service delivery targets. The study concludes most of the provinces have revealed that there are no improvements towards minimization of financial risk indicators. It is recommended that public sector agencies leadership must continue to monitor the implementation of revenue collection, effective budget and cash-flow management to ensure that funds are utilized for their projected purposes and the entire monies due are recovered. This will add to improved fiscal health, going concern and service delivery in the public sector.

**Keywords:** governance, financial health, debt management, under-spending, going concern, public sector.
**JEL Classification:** E61, H20.

## Introduction

Public sector financial management assists to pull together financial resources, apportion money, expend money, and consider the costs and benefits of particular programs, account for money, and report on funds utilization, and plan for the future (Graham, 2011). The broad-spectrum public puts more significance on fine governance in the public sector. In the public sector, the public is anxious that public sector programs are well managed and achieving their objectives with better lucidity (Barrett, 2004). Public sector financial management coupled with good governance is an indispensable ingredient of the growth route of any particular nation. Financial management transformations in the public sector are imperative in that they lead to prudent allocation of financial resources (Njenga, Omondi, & Omete, 2014). According to the Auditor General's Office of South Africa (2015) their audits to ascertain public sector financial health includes a high-level analysis of state agencies' financial indicators to provide management with an overview of selected aspects of their financial management and to allow timely corrective action, where the state agencies' operations and service delivery may be at jeopardy.

The financial health antecedents in the public sector would include under-spending of capital budgets, going concern and debt management. According to The World Bank (2001) objectives of debt management have been overtly defined as overseeing public debt in an approach that satisfies the government's total funding requests at the lowest probable long-term cost, with appropriate regard to the fundamental risks. In light of the worldwide economic crises, the public sector is coming under escalating financial pressure as budgets are compressed on a huge scale at the same time as demands for public services are mounting (Bandy, 2013). To that end, public sector has espoused private sector practice in accounting, administration and public finances management (Blidisel, Farcane, Popa, & Tudor, 2010).

Public administration and management scholars have since acknowledged that financial resources are the means of support of public agencies (Kioko, Marlowe, Matkin, Moody, Smith, & Zhao, 2011) and their management is a major concern to public sector's financial health. In this verdict, attainment of the rudiments of expenditure control and sustainability of deficits is typically of the essence than exploitation of the scope for effectiveness gains pledged by strict public financial management systems (Riechel, 2002). According to Stoker (2006) the paradigms


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of habitual public administration and new public management sit uncomfortably with connected governance.

Against this backcloth the study seek out to scrutinize governance and financial health in an emerging country's public sector. The majority of the paper covers the contribution of the study, theoretical framework, literature review, methodology, findings and discussion, conclusion, and implications of the study.

## 1. Contribution of the study

Incisive studies on governance and financial health in South Africa's public sector, focused on information supplied by Auditor General on Provincial Audit Outcomes are fairly peculiar in the literature. More so, the study appends to the body of knowledge in that it is concentrated on the South African context with reference to governance and financial health risk issues in the public sector using content analysis. A study in the background of solitary country is of the inherent nature, since one precise nation has its unmatched features which allow espousal of the implications.

## 2. Theoretical framework

The study has been directed by the two theories namely, Agency theory and Stewardship theory. Governance hassles may take place in relation with numerous principal-agent affairs as well as stewardship matters. The research study employed the two theories owing to their interconnection, especially in discourses concerning public sector financial management. Unequivocally agency theory is engaged at the pervasive agency affiliation, in which one party (principal) entrust work to another (agent) (Eisenhardt, 1989), where the agent executes on behalf of the principal. Agency (Principal-Agent) Theory in economics makes articulate liability relationship management (agent) to shareholders (principal), and this have created a novel public management and administration (Malmir, Shirvani, Rashidpour, & Soltani 2014) which involves endeavours to establish health financial management in the public sector. The agency theory in public administration and public financial management drives agents to perform and be responsible to their citizens' comfort. In public sector setup the general public represent the principal contrasting of private sector, where the shareholders are the principal, and the public sector leaders represent the agents. The agents have the duty of being liable to the financial health of the public sectors by maintaining good governance.

More so, Stewardship theory, as developed by Donaldson and Davis (1991 & 1993) has viewed stewards as servants of someone or something greater than themselves, committed to their work, and had the discretion to take risks on behalf of their masters (Cribb, 2006). Nevertheless, from the public sector management standpoint, stewards are public servants helping the needs of populace in the most economic, efficient and effective manner (Jordaan, & Fourie, 2013). Stewards recognize that there is a trade-off between personal and organizational needs, and prefer to work for organizational needs (Cribb, 2006; Davis, Schoorman, & Donaldson, 1997) and seeks to attain organization's objectives. The stewards work for organizational needs and in turn the conduct payback the principals who are the citizens (Davis, Schoorman, & Donaldson, 1997). Stewardship theory realizes the worth of formations that endorse the steward and tender supreme sovereignty built on trust (Jordaan, & Fourie, 2013). An assortment of concepts of stewardship entail it to be a role of public sector accountable for the wellbeing of citizens and concerned about the trust and legitimacy with which its activities are seen by the general public (Saltman, & Ferroussier-Davis, 2000).

## 3. Literature review

Having resonance financial management and reporting in the public sector is an imperative contributor in realizing superior transparency, accountability, fiscal responsibility and, hence, enhanced governance (Barrett, 2004). In an exertion to prop up better competence, efficacy and accountability in the Australian public sector, they espoused accrual accounting fundamental to financial management developments (Barton, 2009). According to Honoré & Costich (2009) the nonexistence of apt financial management efficiencies has encumbered progress in growing the area of public finance and the need of elementary financial management knowledge and dexterities.

Governance hold close the engagements set to endorse that the predictable upshots for interested parties of the society are patent and realized. The notion of governance has become an elementary slogan transversely in social and political sciences (Kooiman, Kooiman, Bang, & Kooiman, 2003). The basic rationale of fine governance in the public sector is to make positive that entities conquer their intended targets at the same time as performing in the public interest all the time. According to Howard (2005) the push to relay corporate governance arrangements from the private sector into the public sector are an expression of in progress search for traditions to get better accountability and performance. The contrast of the performance of public sector agencies with private organizations exposes that there is deficiency of fitting performance and incompetent financial administrative system (Malmir et al., 2014). Fryer, Antony, & Ogden (2009) posit that the expected augmentations in performance, accountability, transparency, quality of service and value for money have not yet materialized in the public sector.

Translucent public financial management at public agencies level requires public sector institutions and processes that echo those, required by the central government level, in order to spawn healthier accountability and fundamental elements in securing good governance and competence (Ahmad, Albino-War, & Singh, 2005). Further public sector debt also has inferences for chiefly macroeconomic solidity that concerns the central government consequently the key components are recognized, with a meticulous focus on local government debt supervision and management (Ahmad et al., 2005). More so, the superlative financial management approach to assume depends on the conditions, such as the value being created, the framework, or the nature of the task (Alford, & Hughes, 2008). Consequentially there is need for public financial management metamorphosis at public agencies governance level. This needs a guarded definition of priorities for action and the willpower of apt pacing and sequencing of improvement (Riechel, 2002). Many countries set getting better accountability to the legislature and to the public as one of the principal objectives of their reform initiatives (Curristine, Lonti, & Joumard, 2007) hence the examination of financial health in the public sector.

## 4. Methodology

This study is centred on an interpretative philosophy which observed evocative and emblematic content of qualitative data (Maree, 2013) from 24 General Reports on The Provincial Audit Outcomes for the three periods (2012-2013; 2013-2014; and 2014-2015). The General Reports on The Provincial Audit Outcomes used as prime documents for data analysis were drawn from 8 of the 9 provinces in South Africa. This was exceptionally reached through a process of inductive analyses of qualitative data, where the principal validation was to allow research findings to surface from the frequencies instinctive in the data (Maree, 2013). The Auditor General is renowned and accepted in terms of the Constitution to audit and report on the accounts, financial statements and financial management of all national and provincial departments, municipalities, or any other institutions compulsory by national legislation to be audited by them. As the exceptional Audit Institution of South Africa, it qualifies oversight, responsibility and good governance in the public sector. The information concerning the public sector performance, against determined objectives is subject to audit by the Auditor General in terms of Section 20(2)(c) of the Public Audit Act, 2004 (Act No. 25 of 2004). Data analysis and scoring of the findings for each province was conducted through content analysis using Atlas-ti qualitative research data analysis software. Scoring of the items was basically dichotomous, where an item scores 1 if the findings by Auditor General were unfavorable, and 0 if it is favorable, without any consequence for each undisclosed item.

## 5. Findings and discussions

The Table 1 below reflects that most of the public sector agencies in different provinces are experiencing financial health risks (debt management, under-spending and going concern risks). Four of the provinces (Eastern Cape; Limpopo; Mpumalanga; North West) have 100% score for all the three periods (2012-13; 2013-14; 2014-15) under review, whilst Free State has 78%, Gauteng has 44% showing a moderate financial health risk management and Western Cape reveals a zero score. In the Western Cape province most of the public sector agencies maintained good practices regarding financial health, and there was significant improvement in debt collection and capital expenditure, resulting in the status of their financial health convalescing. Those provinces with a 100% and 78% scores have failed to radically improve on financial risk indicators management including failure to collect outstanding debts within the acceptable 90 day period.

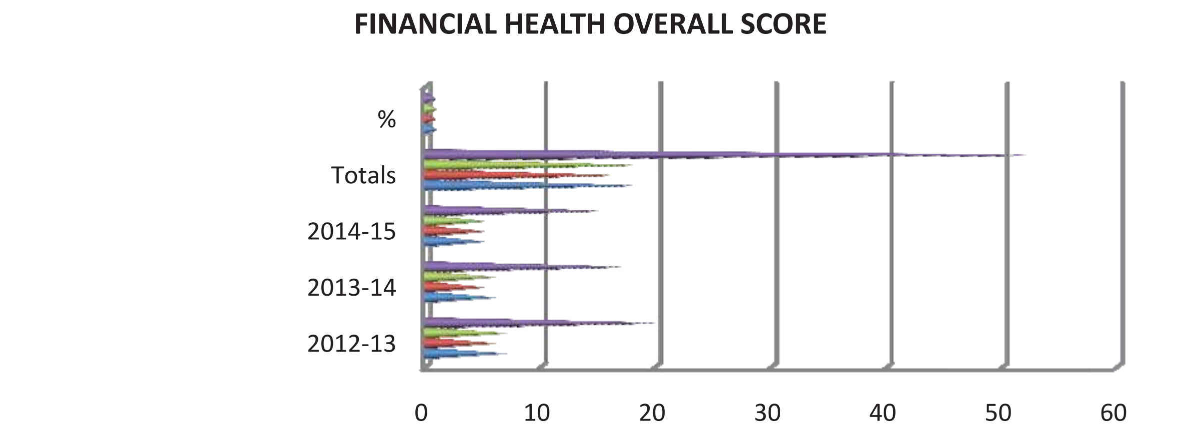
Table 1. Analysis by province

| Province | 2012-13 | 2013-14 | 2014-15 | Totals | % |
|---|---|---|---|---|---|
| Eastern Cape | 3 | 3 | 3 | 9 | 100% |
| Free State | 2 | 3 | 2 | 7 | 78% |
| Gauteng | 3 | 0 | 1 | 4 | 44% |
| Limpopo | 3 | 3 | 3 | 9 | 100% |
| Mpumalanga | 3 | 3 | 3 | 9 | 100% |
| North West | 3 | 3 | 3 | 9 | 100% |
| Northern Cape | 3 | 2 | 0 | 5 | 56% |
| Western Cape | 0 | 0 | 0 | 0 | 0% |
| **TOTALS** | 20 | 17 | 15 | 52 | **72%** |

Most of the provinces have shown a lapsed or little progress in the sufficient monitoring and oversight of the cash flow, expenditure and debt management processes at a number of departments. This resulted in almost all the monies payable to the provinces, not collected, capital projects not appropriately managed, suppliers not paid on time, and cash shortfalls to bring on the service delivery targets. The contributing factors on the regression by the public sector agencies on their management of the capital budget included the increase in accruals, money not spent for intended purposes and poor project management with delays in capital projects.

More so, from the Table 2 below it is proposed that all the three financial risk indicators are above moderate levels in the public sector. That is capital budget under-spending risk has 72% score, going concern risk has 67% score and debt management risk has 75% giving an overall risk score of 72%.

Table 2. Analysis by financial risk indicator




| | 2012-13 | 2013-14 | 2014-15 | Totals | % |
|---|---|---|---|---|---|
| TOTALS | 20 | 17 | 15 | 52 | 72% |
| Underspending-Capital budgets risk | 7 | 6 | 5 | 18 | 75% |
| Going concern risk | 6 | 5 | 5 | 16 | 67% |
| Debt management risk | 7 | 6 | 5 | 18 | 75% |

Most of the public sector agencies do not incessantly implement effective cash-management controls and also most departments in the provinces are unable to address capital budget under-spending hence resulting in not delivering their mandated services. Some of the agencies had cash shortfalls on the subsequent years' appropriations, representing that funds billed for capital assets would have been used for other operational expenditure. The under-spending of capital budgets indicates to poor project planning and management and to poor cash-flow management.

Considering debt management in the provinces, there was no improvement on the number of days debt had been outstanding, and unfortunately there has been no progress in the number of agencies with a debt-collection period of more than 90 days. This means that without stiff and effective controls around revenue and debt management, there is a risk of underperformance on services funded by own revenue. This shows that there is derisory maintenance of proper legal and accounting records for all debtors, that is there are no correct processes to take action and follow up long-outstanding debt, including legal action. Therefore the provinces leadership must design measures to address this risk to guarantee their sustainability. The analysis reflects that public entities persist to rely on government funding to keep going without putting instruments in place to ensure that amounts due to them are collected. Overall poor debt management has an impact on the prosperity and effective management of public entities.

## Conclusion and implications

The study concludes that generally financial health concerning debt management, going concern and capital budget under-spending in South Africa's public sector is at risk. Most of the provinces have revealed that there are no improvements towards minimization of financial risk indicators. There was an overall regression in the public agencies' financial health because certain entities were unable to manage their debt-collection periods for long-outstanding debts and spending against the budgets. As a result, the expenditure of these entities exceeds their revenue and they face challenges in paying their creditors and liabilities due. This administration of long-outstanding debt has a negative impact on the effectual use of human resources to attend to non-service delivery functions and this inclination has a downbeat effect on future cash flows for the public agencies and the capability to deliver prime services.

The leadership in public agencies must ensure that accepted financial reporting and analysis should be prepared and supported by debtors' accounts reconciliation to spot early debtor payment trends and probable bad debt. Public agencies must revise their debt management strategies and should update and stringently enforce the strategies. More so, the public sector entities must utilize the ever growing Information Technology (IT) system controls over payments receivable and invoicing. The IT systems if implemented and regularly improved would assist in monitoring and enabling debt collection subsequently, reducing debt-collection period and improving overall cash flows.

Public agencies executives must ensure that budgets are pragmatic, supported by convincing assumptions and are accurately monitored. Critical to this are accounting officers or authorities who should ensure that controls are in place to monitor and manage the budget. The leadership therefore is also encouraged to certify that there are sufficient project management systems in place to deal with planning, monitoring and oversight of the capital projects and budget process. Agencies with sturdy financial performance, financial position and cash management practices are able to maximize their funds and deliver successfully on their mandates. All in all the public sector agencies leadership must continue to monitor the implementation of revenue collection, effective budget and cash-flow management to ensure that funds are utilized for their projected purposes and the entire monies due are recovered. This will add to improved fiscal health and service delivery in the public sector.

However, this research study could guide to specifics for further researches involving other emerging countries and developing countries, which can present more discerning results concerning governance and financial health in emerging economies' public sector and other allied topics.

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