



Agency Theory in University Governance and the Role of Internal Audit: From the Private Sector Perspectives to the Case of Vietnamese Public Higher Education Institutions

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Abstract. Along with the trend of applying business governance in Vietnamese public higher education institutions, agency problems become an important issue that the public higher education institutions have to face. There are many ways to reduce agency problems, and one of them is to take advantage of the internal audit system. The paper reviews the literature on the relationship between agency theory and internal audit in public higher education institutions, which is quite rare. This study analyzes the case of Vietnam, a country where university governance system has had a lot of changes in recent times with the development of autonomy mechanism. The research raises the importance of internal audit function in university governance and provides policy implications for regulators and university administrators by adopting internal audit to reduce agency problems.

Keywords: Agency Theory · Corporate Governance · University Governance · Internal Audit · Public Higher Education Institutions · Vietnam

1 Introduction

Agency theory [20, 21] has been used to explain the conflicts and relationships between the principals and the management in companies. It has also been used to discuss the relationship between these two parties in the public sector [12, 31]. In response to the lack of explanation of the theory to understand more thoroughly on internal audit in existing literature [30], we intend to use agency theory to explain the roles of internal audit.

While corporate governance has been drawing the interest of researchers, higher education governance, especially the ones with state ownership involvement, has still not been adequately examined. For corporate governance, the agency conflicts between the principals and the agents have been discussed. The ownership in this relationship is quite clear. In comparison with state-owned companies, the state-owned universities with autonomy are different in terms of the characteristics of the education product.

Therefore, the roles of internal auditors to serve the shareholders in state-owned universities are different.

While analyzing 471 papers from 64 journals published between 2005 and 2018, [22] stated that emerging economies are largely absent in prior internal audit research (no distinction between the private and public sectors). The roles of internal audit in higher education governance in emerging countries with unique characteristics like Vietnam are interesting to investigate. While sharing a lot of common cultural characteristics with China such as Confucianism, it has always wanted to be independent of its big neighbor. The political model with one party mechanism and market-oriented socialism is similar to China but the implementation is not as strict as in China. Influenced by France and the US throughout history, it's opened to Western culture while the economic development has been far behind these countries. These all have impacts on higher education governance characteristics which are similar and different from China¹ as well as affected by Western countries, and later influence the roles of internal auditors.

Our study investigates the role of internal audits in higher education governance in Vietnamese public universities. We base on agency theory to discuss the impacts of internal audits on university governance. Internal audit contribute to reduce the information asymmetry and reduce agency problems in public higher education institutions. These findings imply that internal audit helps improve university governance while the improvement in governance mechanism makes it easier for internal audit to conduct its functions.

Our research has several contributions. First, it adds to the literature on the role of internal audit in governance in the public sector using agency theory. Second, the study is conducted in an emerging country with a unique setting.

Our study has 4 sections as follows. Section 2 reviews the literature. Section 3 discusses the agency theory and role of internal audit in Vietnamese higher education institutions. Section 4 concludes.

2 Literature Review

2.1 Corporate Governance and Agency Theory

According to [33], "Corporate governance is the system by which business corporations are directed and controlled". Corporate governance links to practices and procedures to ensure that a company is run in such a way that it achieves its objectives [7]. It describes all the influences affecting the institutional processes, including those for appointing the controllers. Corporate governance has several objectives: growth, transparency, leadership, social responsibility and trust, protection of shareholders and company assets, and it plays a key role in determining a company's control environment [18]. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, as well as spells out the rules and procedures for making decisions

¹ Managing neo-liberalism with Chinese characteristics, Chinese approach to the education market is governance with strong state presence in public sector management through bureaucratic governance in practice [29].

on corporate affairs [33]. Corporate governance theories are rooted in agency theory with the moral hazard implications, developing further within stewardship theory and stakeholders theory and evolving at resource dependency theory, transaction cost theory, and political theory, and then added by ethics theory, information asymmetry theory and theory of efficient markets [4]. Among these, agency theory, stewardship theory, stakeholder theory are all essential ethnocentric [45], and agency theory has served as the most influential viewpoint in the field of corporate governance research, policy making and practice [46].

Agency theory “discusses the problems that surface in the firms due to the separation of owners and managers and emphasizes the reduction of this problem”. In other words, as the owners (shareholders) are described as principals and the managers as agents (Tan [42]), agency theory studies the problems and solutions linked to the delegation of tasks from principals to agents in the context of conflicting interests between the parties [26] - then it is also called a principal-agent theory. The theory has a long-term development, from when [3] found the research, to date.

2.2 Agency Theory and Corporate Governance in Public Entities

2.2.1 Agency Theory and Governance in the Public Sector

The agency relationship in the public sector is more complicated than in the private sector. Three main sets of principal-agent relationships are the relationship between electorate as principal and legislature as an agent, between legislature as principal and government as an agent, and between government as principal and official as an agent [40]. Among these principal-agent relationships in the public sector, at the organizational level, the last one should be focused on. There is a conflict of interest between “chief officials”, who have incentives for larger budgets, and ministers, who prefer to eliminate any budgetary slack. The officials have access to more information [10].

The accountability in the public sector is linked to the extent of decentralization of an activity [16]. In a meta-analysis of [38], five factors that constitute the common basis of existing models in the research literature are financial condition; inter-governmental subsidies received; political competition; size; and wealth of citizens. These are all significantly associated with transparency.

2.2.2 Agency Theory and Governance in State-Owned Companies

According to [10], the corporate governance of SOEs refers to the ownership function of the state, the supervisory role of the government, the monitoring role of the board of directors, and the agency implications of contracts between the government and its agents. The principal-agent problem is the relationship among a series of conflicts of politicians, ministries, board of directors, and company managers [36]. Political principals can intervene in the operation of an SOE by pressuring the board to take controversial decisions related to investments, procurement, leverage, or employment. SOE managers also want to preserve a strong connection with the government [41] to have benefits such as reduced bankruptcy risk, tariff protection, subsidized credit, exclusive rights to operate on certain markets, informational advantages concerning future regulatory changes, and the inflow of annual subsidies and state aid [24, 32, 34]. Managers of SOEs know

that if they fail to reach their targets, the enterprise still runs with the support from the government.

[39] argued three main reasons why political control over firms reduces the efficiency of large SOEs: (1) The incentives for managers to improve the productivity of SOEs are inevitably undermined due to a lack of initiatives. (2) State control over firms can induce non-productive rent-seeking activities to crowd out productive profit-maximization activities. (3) The allocation of formal authority to government officials over large SOEs makes them unable to adapt to the local demands of the product market for which a certain amount of local information is required.

In emerging economies, most board and management positions in SOEs are assigned to politicians and officials that seek to gain political benefits instead of maximizing economic efficiency. State officials and politicians are strongly associated with the management and oversight of SOEs [14]. The primary purpose of the board of directors is to oversee the managers' activity, validate the strategic decision of the CEO, and represent the interests of shareholders [2]. Boards of directors must have the necessary authority, competency, and objectivity to carry out their strategic guidance and monitoring functions [33].

Board and management appointments in SOEs rely on trust, personal loyalty, and political commitments [35]. SOE managers and board chairpersons are often part of the higher-level political elite or aspire to become part of this elite. Consequently, positions on the board of directors of SOEs are usually distributed to political party members and government officials. Therefore, the presence of independent directors is expected to reduce the corruption linked to the governmental apparatus [15].

2.2.3 Agency Theory and Governance in Public Higher Education Institutions

According to [17], the different forms of the organisations in the public sector and differences in the nature of the activities carried out by the organisations create the variations of principal-agent relationships. Universities provide education products, which are popular and attached to the social goals of the government, therefore having a different principal-agent relationship.

For public universities, corporate governance and agency theory has been studied by several authors [5, 21, 25, 29]. According to [5], Carnegie and Tuck, the enterprise governance framework of PAIB (2004)² is too narrow an orientation for the public university. Corporate governance (generally described as the conformance framework) is considered as a key component of university governance. Public universities' governance in developing countries can face numerous challenges such as large student numbers, overstretched facilities, insufficient government support, inadequate induction of new staff, resistance to change. Relating to the principal-agent relationship in public higher education institutions has analyzed and stated that, with this type of institution, the principal can be a ministry of science and education, the management board of a university, a

² Professional Accountants in Business Committee of International Federation of Accountants (2004) has issued the enterprise governance framework (in *Enterprise Governance: Getting the Balance Right*, New York), which includes business governance (i.e. performance), corporate governance (i.e. conformance), value creation/resource utilisation and accountability/assurance.

president, dean, or department chair. The agents are those actors in higher education who receive assignments, funds and salaries from the principals. Therefore, higher education managers, such as heads of departments are simultaneously principals and agents, while other university staff (professors, researchers, lecturers) are considered as agents. Informational asymmetries and goal conflicts are the two assumptions that are very important to agency theory, also valid and relevant in the higher education context [20].

2.3 Agency Theory and Relationship with Internal Audit

2.3.1 Agency Theory and Relationship with the Internal Audit in the Private Sector

The role of internal audit within the context of agency relationships has been studied quite a long time ago by [1, 8]. Agency theory suggests that individuals tend to make decisions that will benefit them, and so in the cases of shareholders and managers. Even the managers have been hired by the owners (shareholders) and represent the owners' interests, however, they can manage the firm different to the owners' strategies, or serve their own benefits, which reduces the shareholders' wealth. For example, it can be possible that the owner's objective is to maximize the firm's value, that is, to maximize the market value of the firm's equity, while managers aim for their short-term goals, such as increase sales, increase market share, maximize profits, etc., to increase their salary, their bonus or their reputation. Because of that, historically, the relationships between these two subjects are the reason for the existence of the internal and external auditors. According to IIA³, different from external auditors who mostly focus on financial reports and report to shareholders or members outside of the organisations' governance structure, internal auditors do the audit work to evaluate and improve the effectiveness of governance, risk management and control processes. They provide assurance and consultations to the board and senior management within the organization's governance structure, to ensure that the organization is managed and run on the right track, following the board's strategies and helping the management fulfill their duties to the organization and its stakeholders. Internal audit is often organized under a department attached to the Board directors and the Audit committee (sub-committee of the Board) has the task to oversee the internal audit function. Providing benefits to both the two parties, owners and management, however, they are often questioned on their independence, as they report to the shareholders, but be nominated and paid by the board of directors (agents represent the shareholders but may not be on the side of the minority shareholders (principals), or even more complicated as in reality, management is the one who signs the payroll for payment to internal auditors. [1] has proposed an agency theory framework for internal auditing research, and mentioned that agency theory contends that internal auditing, in common with other intervention mechanisms like financial reporting and external audits helps to maintain cost-efficient contracting between owners and managers. However, according to [46], although the study of agency problems between owners and managers as proposed by the classical agency perspective is important, developing countries primarily present a nexus of agency problems termed principal-principal conflict.

³ iaa.org.uk.

2.3.2 Internal Audit to Reduce Agency Conflicts in the Public Sector, Especially in Public Higher Education Institutions

The auditors themselves are a party to yet another agency relationship since the principal who appoints the auditor will not know whether the auditor is performing the level of service agreed upon [40].

2.3.2.1 In the Public Sector

[12] find that internal auditors seek to legitimize their position through compliance and performance audits. When performing these dual roles, internal auditors are not affected by governance rules and managerial influence, but need to perform communicative action because of financial and managerial capacity issues. This is especially important in developing countries.

2.3.2.2 In State-Owned Companies

Due to the complex principal–agent relationship in the state-owned companies, IA is a tool to help reduce the agency cost by providing an opinion on the compliance of the managers, the effectiveness of internal control and risk management with a professional framework. These will certainly improve the accountability of firms.

2.3.2.3 In Public Higher Education Institutions

One of the important goals of universities is to have a high rank in the global rankings. [37] find that universities that have a more mature educational innovation governance in place demonstrate a tendency to work on educational innovation projects, which contribute to strategic changes that will affect teaching, improving research and its links to the society. On the way to develop higher education in an emerging country like Vietnam, achieving this goal while balancing other goals such as profitability, mass access of students, etc. will affect managers in making decisions. The board with the primary function of overseeing and validating these decisions will need the consultation of the IA to control managers' activity when making innovations for development.

The role of internal audit in enhancing university governance effectiveness and promoting accountability has been explored by several authors, for example [6, 13, 47]. However, the role of internal auditors in agency problems in public higher education institutions is rarely studied. We can find the research on the effect of internal audit practices on financial management with the case analyzed from one university in Ghana as an example. To them, the public sector embodies an owner-manager relationship, and to create the third party trust (stakeholders) to rely on the performance reports of the organization, and the functions of audit portray as an important monitoring strategy of public financial management and increasingly as an activity for the improvement of public institution financial management. Or [6] in analyzing the role of internal auditors in enhancing a university's governance and developing the internal audit evaluation framework has also based on the agency theory. However there is no other prior research on the roles of internal auditors among the relationship between owners-managers of public higher education institutions. From the literature review, we propose the following hypothesis:

H1: Internal audit is positively related to the agency problems in public higher education institutions.

3 Agency Theory and Roles of Internal Audit in Public Higher Education Institutions in Vietnam

3.1 University Governance and Autonomy

Education development in general and higher education in particular has always been considered as a key and prioritized field in economic and social development policies of most countries around the world. In Vietnam, over the years, the policy system for higher education development has always been revised, supplemented and gradually perfected and most recently the Law on Higher Education no. 34/2018/QH14 (2018) which amended the Law on Higher Education no. 08/2012/QH13 (2012) has created an important legal basis, promoting university autonomy, effectively using resources, well implementing management and renovating the governance of higher education institutions. Accordingly, higher education institutions have been gradually given autonomy to improve the quality of training, scientific research and technology transfer, strengthening the cohesion between training activities and the labor market demand. On the basis of analyzing new points in higher education development policy in general and university governance innovation in particular as well as the actual situation of implementing university autonomy mechanism - a core content of higher education development policy in Vietnam, the position and role of internal audit in university governance is extremely important.

The previous Law on Higher Education of 2012 had officially mentioned public university autonomy but did not clearly stipulate on university autonomy rights and university governance [44]. Regarding university governance, although the University Council is an important university governance institution, the composition, roles, functions, duties and powers of the University Council in public universities have not been clearly defined. Therefore, in fact, the concept of a University Council is still a formality, the council does not have real power in deciding on the principal's personnel and important issues of the universities. The autonomy in professional activities (training, research, international cooperation, etc.) of higher education institutions is still limited [28]. The state management model for higher education still has many points that are not suitable for university autonomy conditions: the regulations on finance and assets were not completely consistent with the policy of implementing university autonomy; no regulation on the right to enter into a joint venture, association or form an enterprise to apply scientific research results; the mechanism of budget allocation for public higher education institutions had not attached to the criteria reflecting the quality and output results, so the competitiveness among higher education institutions has not been promoted.

The Law on Higher Education (2018) then has brought more than 40 amendments and supplements on: (a) Synchronizing the autonomy mechanism; (b) Renovating the university governance mechanism towards efficiency improvements of state management on higher education in the context of university autonomy, gradually reducing the

direct intervention of state management agencies to the higher education institutions; (c) expand academic and organizational autonomy to improve the quality of teaching staff and training quality; (d) international integration [44]. The content of university autonomy mentioned in the amended Law is fully outlined in the 2007 Lisbon Declaration of the European University Association (EUA), which includes four key features of university governance to measure the degree of autonomy of higher education institutions, including organizational autonomy, financial autonomy, autonomy in human resources and academic autonomy [11].

The 2018 Law on Higher Education stipulates that the University council of a public university is the governing organization, exercising the rights of representation of the owner and related parties, determining the responsibilities and powers, the number of quantity, structure and responsibilities of members of the Board of Directors (the total number is odd, maximum 25 people and minimum 15 people, including members inside and outside the university; faculty representatives account for at least 25%; non-university members account for at least 30%).

In the higher education system in the world, the University Council has different names depending on tradition or geographical area, such as “Board of Trustees”, “Board of Regents”, “University Council”, “Board of Directors” etc., but they are all by nature the most authoritative governing body in the structure of a university. This is a very commonly used mechanism in higher education administration in countries around the world. The basic functions of the Council are to deal with the following issues: appointment; basic education policy; property preservation; comprehensive and physical development; financial policies and controls; public relations policy; fundraising [9].

In general, in Vietnam, the University council of public and private universities’ functions and duties are generally the same. The difference is that due to different ownership, the proportion of non-university members is different: this ratio is usually higher in private universities than in public universities; The council of private universities usually has many members who are alumni (off-campus), members appointed by the government, honorary members. These members help build the university and raise funds. The terms are various, usually from 3 to 5 years. The university’s internal members are represented by lecturers and researchers. [19] in their study stated that a corporate governance model is an appropriate form for a university since its organizational structure, management model and operation are similar to an enterprise.

A study by [42] shows that in Vietnam, among 23 public universities piloting university autonomy according to Resolution 77/NQ-CP, only 20/23 universities have a University council (accounting for 86.9%). In the structure of the council, the average proportion of members belonging to the university is 72.56%, and the percentage of members outside the university has not yet met the regulated rate of at least 30%. As an example, Hanoi University of Science and Technology has the University Council for the 2020–2025 term consists of 23 members, of which 14 are internal members (61%), of which 6 people (26%) are lecturers (if including faculty and institute leaders); outside of the university: 9 people (39%). With the structure and composition of the members of the University councils, it can be seen that “the internal members from the University account for a relatively large proportion who hold the managerial positions of principal, secretary of the party committee, vice-principal, the president of the trade union, leaders

of the departments/faculties, so it is difficult to separate their performing tasks and bring an objective voice in the meetings of the Board of Directors". Besides, in Vietnam, the ownership of state-owned universities is the government, with a representative from the Ministry of Education and Training. However, in the University Council of a public university, there is only one representative comes from the Ministry of Education and Training, while other university council members come from inside of the university and outside from enterprises as mentioned. The separation between the principal and the agent seems to be large and the information asymmetry is high.

3.2 Role of Internal Audit to Reduce Agency Problems

The growing need for transparent financial information from interested parties in a market economy requires regulations on internal control and internal audit. In 1994, for the first time, the State Audit had been directly under the Government and then under the National Assembly from 2006. The Law on State Audit no. 81/2015/QH13 has considered the internal control system activities as the additional basis for determining the audit objectives, content, scopes and audit method. Law no. 88/2015/QH13 on Accounting also issued in 2015 has more details on the internal control system and provides the definition of internal audit, which means inspection, assessment, and supervision of the completeness, appropriateness, and effectiveness of the internal control system. Although both internal audit and internal control refer to two important processes in the organizational control system, the Law's definition shows that internal audit seems to be more important as it covers the internal control process in its assessment. The Decree on Internal audit no. 05/2019/ND-CP also emphasizes the tasks and functions of internal audit activities.

In the public higher education institutions, the role of internal audit and internal control systems in governance and administration are acknowledged. However, since public higher education institutions have implemented the subsidy mechanism for a long time, they do not have much experience in setting up internal audit and internal control systems. Ineffective and formalistic performance of the internal audit and internal control systems does not assist university councils and administrators in the planning and running of specific university activities for the following reasons: (1) In most public universities, the leadership has not paid enough attention to establishing a separate internal audit and internal control division in the organizational structure to perform the task of risk management and compliance and assigned the Inspector-Legal department of the university to concurrently hold this function; (2) Most of the public higher education institutions focus only on quality and completing assigned political and training tasks, not paying attention to efficient use of finance. Financial management is only in monitoring reports, that do not cover improving efficiency of financial resource use and investment; (3) Overlap in regulations of legal documents, in control and inspection functions of different organizational units. The above situations are the major causes affecting the control environment in public higher education institutions, preventing the internal audit and internal control system from complete and effective performance.

University autonomy is considered an inevitable development trend, a necessary condition for universities to exist and develop. It requires adopting an appropriate university governance model. University governance is the process of establishing rules and

systems for the management and control of the entire operation of a university in the context of autonomy. Performing an internal audit in the university helps prevent management risks and avoid serious mistakes. In the context that most Vietnamese public higher education institutions have not adopted an internal audit function, it is important that they need to realize the role of internal audit in reducing agency conflicts. Through testing, evaluation and consulting activities, an internal audit provides independent and objective assurances and recommendations on the following contents: (1) The entity's internal control system has been properly established and operated in order to prevent, detect and handle risks of the entity; (2) The entity's governance and risk management processes ensure efficiency and high performance; (3) Operational objectives and strategic objectives, plans and tasks achieved by the unit. For public universities, in principle, an internal audit department has to be set up under the University board and internal auditors will be recruited and approved by the University council. Internal auditors have the task of auditing the University units (faculties/departments), which operate under the management of the University's management board. An audit report with comments on the strengths and weaknesses of the University's internal control and risk management systems as well as assessing the University's objective achievements will be sent to the management for feedback and adjustment, and to the University council. As the University council has many members outside the university, and the owner's representative is in fact only one representative of the Ministry of Education and training, it is necessary that they can receive a complete, honest, and objective report on the University's activities. That may reduce information asymmetry, reduce agency problems in case the University does not operate in accordance with the University council's policies, or having problems related to group interests in university governance, such as problems in the enrollment process, tuition collection or investment project management. Agency problems may be resolved with certain solutions: (1) increasing salaries or rewarding managers - this is not easy to do with the limited resources of public universities and the salary grading scale policy of public organizations; (2) stock bonuses and executive share option plans (ESOP) - not possible in a public unit, and (3) strengthening measures to supervise manager actions by setting up internal audit function - this is the most feasible. A team of qualified internal auditors, along with setting up a strict and transparent sanctioning system for managers who fail to fulfill their responsibilities and cheat, will contribute to increasing the reliability of the financial information provided by management as well as better control the management's activities.

4 Conclusions

Obviously, agency problems are inevitable in every organization, whether it's public or private. It is important to find mechanisms and measures to reduce this conflict. Internal audit, if properly recognized, will promote the reduction of agency conflicts in Vietnamese public higher education institutions if the internal audit department is set up properly. The fact that if the Ministry, the University council chairman and members, the managers can see the role of internal audit and the influencing characteristics of the relationship between internal audit and university governance, they can have appropriate directions for practical application.

There are economic, political and cultural characteristics of Vietnam that may impact the relationship between internal audit and university governance. Relating to economic characteristics, as an emerging country, the budget of the government for the universities is not large. The university autonomy process is one way of reducing the burden of the budget on education. The universities will be affected because of reducing government influence and increasing market competition. The principal-agent relationship has also changed from the high impact of government to more independence while the university governance is still in the developing process. This will make the role of IA more important but also bring challenges for IA to conduct their work. As for political characteristics, Vietnam is a market-oriented socialist country with one party mechanism. While achieving economic goals, it needs to achieve social goals, especially in education. The government still needs its influence on the autonomous universities. The role of the Communist party in university governance, like other state-owned enterprises, is important. It adds to the complication of the university governance with the board and managers. The role of IA in this environment is, therefore, a need. It also needs the communication skills and mechanism to keep its independence while helping the board, the managers as consultants. Concerning cultural issues, Vietnamese culture is affected by Confucianism, which appreciates the harmony among people. Therefore, to reduce agency conflicts, IA will need to work in a professional way to detect the shortcomings of the universities as well as communicate adequately to both managers and the board. On the other hand, Vietnam has the tendency to be open to Western culture and learn from Western best practices. The use of internal audit to balance the principal-agent interests of public higher education institutions in developed countries will certainly be experience that Vietnamese universities must learn more.

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