



Executive summary of the public audit report

DOES THE GOVERNANCE OF MUNICIPALITY-OWNED ENTERPRISES ENSURE THE EFFECTIVE AND TRANSPARENT ACTIVITY OF THE ENTERPRISES

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ABBREVIATIONS & DEFINITIONS

Municipality-owned enterprises – municipal enterprises, acting in accordance to the State and Municipal Enterprise Law, public and private limited liability companies, the shares of which provide more than ½ of votes in the General Meeting of the Shareholders and which belong to the municipality on the right of ownership, as well as companies, in which the municipalities may appoint more than half of members to the company's administration, governance or supervisory body.

CCM – the company, which is controlled by the municipality.

AB – public limited liability company.

UAB – private limited liability company.

ME – municipal enterprise.

SE – state enterprise.

OECD – Organization for Economic Co-operation and Development.

The guidelines of OECD – OECD Guidelines on Corporate Governance of State-Owned Enterprises.

Collegial bodies – the Supervisory and Management Boards of the CCM.

One-person governance body – the Manager of the CCM.

Collegial governance body – the Management Board of the CCM.

Collegial supervisory body – the Supervisory Board of the CCM.

GCC – Governance Coordination Centre. It's a governance coordination office of the state controlled enterprises in the SE 'Turto bankas', which carries-out the functions envisaged in the guidelines on property and transparency.

Property guidelines – the 06/06/2012 Resolution No.: 665 by the Government of the Republic of Lithuania 'Regarding the Confirmation of the List on the Rules of Implementing Property and Non-monetary Rights in The State Controlled Companies'.

Transparency guidelines – the 14/07/2010 Resolution No.: 1052 by the Government of the Republic of Lithuania 'Regarding the Confirmation of the Guideline List on The Ensuring of The Transparency of the State Controlled Companies' Activities.

Common objective – the result, which is awaited from the CCM and fixed in the governance policy of the CCM; as far as possible, the objectives should be quantifiable, e.g., finance objectives.

Finance objective – the awaited value expressed by monetary or percentage index, by which it's intended to pursue the effective governance of the company's finances, sustainable activities and returns for the investor.

Ambitious financial objective – such a financial objective, which significance is assessed by dissociating from the results achieved in the previous years and by intending to come close to the best results of other similar companies.

The analysis of financial indexes – a means for evaluating the current financial situation in the companies and foresee the possible changes in the future.

ROA – return on assets. This is the financial indicator of effective use of the assets of the company. It's calculated by dividing the net profit from all of the assets.

ROE – return on equity. This is the financial indicator of the use of the invested by the shareholders capital. It's calculated by dividing the net profit from all of the equity capital.

Net profitability – a financial indicator, which is calculated by dividing the net profit from the net turnover.

Cross-financing – financing means when loss-making activity is financed from the income received from gainful activities.

CCM portfolio – the compendium of all Lithuania's CCM.

Literature – various descriptive articles from Lithuania and foreign countries, which indicate acceptable or achievable values of financial indicators.

Economic activity – manufacture, commerce, financial or career activity, which is related to the buy and sale of goods, except in those cases when natural persons acquire the good for personal or home economy purposes.

Good – each buying and selling object, including all types of services, works, rights or securities. The buying and selling is considered the transfer or acquisition of the good in accordance to buying and selling, provision, contract agreement or other deals. To the goods are equated items (assets), which are transferred in accordance to the lease or loan-for-use agreements.

SUMMARY

The establishment of municipality's controlled companies (CCMs) is one of the functions of the municipality, by which it is ensured that all of the residents of municipality be able to use public services and these services would be continually provided. The municipality establishes new public services providers only in those cases when other providers do not provide public services or they can't provide them to the citizens economically and in good quality¹. These companies are established from the tax payers' funds and when there are not enough own funds, the investments are made and losses compensated from these funds. The CCM is the property of all the people in Lithuania. Which is why it is not only important to ensure the continuous provision of public services, but the results of the companies should benefit all.

One of the conditions in order for Lithuania to become a member of Organization for Economic Co-Operation and Development is the requirement to increase the effectiveness and transparency of the state controlled companies' activities. In order to achieve this, in 2010 a reform of these companies has started to be implemented. It was decided to apply to these companies those legal norms and standards, which are in accordance to the OECD Guidelines on Corporate Governance of State-Owned Enterprises.

The European Commission evaluated² the progress, which was achieved in this sphere since 2010 and highlighted that it would be wise to use the current situation of active progress and expand the reform of the companies in such a way that the innovative governance principles would be implemented to the CCM. In the OECD Guidelines on Corporate Governance of State-Owned Enterprises, it was noted that they are fitting for municipalities' controlled companies.

The primary recipients of the services, which are provided by CCMs, are citizens, also private economic subjects provide a part of the services. The Competition Council not one time acknowledged that the privileges provided by the CCM do not ensure honest competition and adherence to the provisions of the Law on Competition. Which is why the effective and transparent activity of the CCM is just as important as state owned companies.

It is not mandatory to apply these guidelines, but it is useful in order to be a progressive part of the organization of countries. Some of the municipalities, e.g., the city of Vilnius, after seeing the benefits of changes started the CCMs reform and they intend to implement the in the OECD guidelines enshrined principles.

Because Lithuania wants to become a member of the OECD, a lot of attention is paid to the reform of state owned companies, but the governance of them, up until now, was not evaluated systematically. There are many discussions in the public space about the necessity to better the results of these companies and to increase the transparency of their governance. These reasons lead to the fulfilment of the activity's audit.

We have concluded the audit by envisioning its objective – to evaluate, whether the governance of the CCM ensures the effective and transparent activity. We have concluded the analysis of financial indicators of all CCMs in Lithuania, also in the chosen eight municipalities and thirty-two companies controlled by the municipalities we evaluated the governance of the companies: the

¹ Republic of Lithuania Law on Local Self-Government, 07/07/1994 No.: I -533 (15/09/2008 No.: X-1722 edition), Art. 8 (5), Art. 9 (2).

² „State-Owned Enterprises in the EU: Lessons Learnt and Ways Forward in a Post-Crisis Context“, 2016.

means, which are applied by the municipalities in order to achieve a more professional governance, better strategic planning and management, financial and social results and strategic objectives of municipalities in these companies. We audited the 2013 – 2015 data and in order to evaluate, analyse tendencies and changes fully we used data from other periods.

The state in order to increase the effectiveness and transparency of the state owned companies has improved the governance of them by adopting the needed statutes of law and governance guidelines of the state owned companies, which are based on the good governance principles. Furthermore, state institutions and its companies (Ministry of Economy, GCC etc.) has valuable information in the company governance's sphere. We missed the help from the state in order to improve the governance of the CCM – the guidelines and consultations by the GCC are meant for the state owned companies. Which is why, at the moment, a common methodology is absent for the municipalities and the CCM, which would be prepared by having regard to the peculiarities of the CCM activities.

The principles of good governance practice of the companies in the municipalities are not applied or are only in part applied; there is a lack of consistent and comprehensive view towards the control of the companies. There is a lack of initiative for the municipalities to separate commercial and non-commercial CCM activities, determine certain objectives for the companies and to control whether or not the companies reach them. Not in all cases the municipalities strive to achieve, that independent persons unrelated to the activities of the company be included to the composition of the boards, not all important information about the CCM is made public and the reward systems for the managers of the companies and control bodies are not sufficiently increasing the effectiveness.

Upon evaluating the effectiveness of the CCM activities, we analysed the financial indicators (the return on equity, return on assets and net profitability), the dividends earned by the CCM and the profit part allocated to the municipality's budget. The non-application of the good governance practice and a popular view that the sole purpose of the CCM is meeting the public interest without any regard to the budgets of the municipalities have an impact on the results of the CCM. Dividends and profit instalments are used to realize the municipalities' programs and contribute towards the reduction of the deficit of the municipalities' budget. Not all of the CCM can strive to achieve profitability and the yield of bonds. However, as we have ascertained, even those companies, which carry-out non-commerce functions, are not governed in order to achieve financial sustainability, because only financially able CCMs can renew the depreciated assets of the company, plan expansion, improve the quality of services and reduce the price for consumers of the services.

The activity results vary: part of companies are tendentiously making losses, however there are profitable companies, which generate return for the municipalities. Common results of the CCM portfolio are not good. In the year of 2015, the CCM portfolio's return indexes were negative. In this situation, there is a threat that the financial sustainability of the companies' portfolio in the future will not be ensured.

In the end of 2015, there were 271 CCMs active in the country; common value of capital amounted to 1 257 M of Euros. About 10% of CCMs carry-out economic activity unrelated to the functions of municipalities. The current changes in the Law on Local Self-Governance³ shall limit the possibility of municipalities to establish new controlled companies, which carry-out economic

³ The Law on the Amendment of 4, 9 Articles and Supplement of Articles 9 – 11 of the Republic of Lithuania LR Law on Local Self-Governance No.: I-533 4, 9, 08/11/2016 No.: XII-2741.

commerce activity. However, by using criteria fixed in this Law, it is also important to evaluate the necessity of the now acting companies. The municipalities should periodically discuss the necessity to have controlled companies, because the initiative to improve the CCM portfolio is not enough – the CCM should be waived when private economic subjects provide economically and good quality services. Even though there are CCMs conducting similar activity, the municipalities establish the joint ventures only in exceptional cases and even more seldom they entrust the functions of providing public services to another company controlled by another municipality.

In order to use the accumulated experience of the state owned companies, it would be useful, by incorporating the municipalities, to prepare and affirm the CCMs governance's recommendation type guidelines and, based on competence, provide methodical help to the municipalities on how to effectively implement the rights of owners towards the CCMs and achieve better activity results. By mutual cooperation and cooperating with the institutions responsible for the reform of state owned companies, a consistent and focused implementation of common modern governance principles in all municipalities would be ensured. By experiencing least expenditures, the biggest benefit would be created. The common CCM governance policy would provide means to establish objectives to the companies according to same criteria and evaluate their activity results, the help from GCC would increase the competence of municipalities and CCM in the spheres of board's formation, strategic planning and increase of transparency. The municipalities, by using the experience of good governance practice in the state owned institutions, should show initiative and implement the principles of innovative governance in the controlled companies. It would have a positive effect to the budget of municipality and the quality of the services provided to the residents, would form a positive society's opinion on the municipality.

After evaluating the evidence gathered during the audit (by applying the analysis of statutes of law, documents and data, calculation and comparison methods), we provide the results of the audit. If the laid down recommendations would be properly carried-out, an effective municipalities controlled companies' resultative governance and transparent and effective activity basis would be created, and the results of the companies would give a bigger benefit to the society.

We have formulated the conclusions of the audit after researching national statutes of law regulating the establishment, governance of the CCM, documents regulating the work of institutions implementing ownership rights, OECD company governance guidelines, statistical and research data of Lithuania.

CONCLUSIONS

1. The state, in order to increase the effectiveness of the state owned companies' activities and transparency has adopted the necessary statutes of law, the guidelines of governance of the state controlled companies, which are based on the principles of good governance. However, the carried-out governance analysis of the CCM has shown that good governance practice principles are not applied in the municipalities or they are applied only in part, there is a lack of consistent and comprehensive view towards the governance of companies:
 - 1.1. the municipalities do not advance common objectives for the controlled companies, create a clear and objective evaluation system of companies' activities indicators, ensure the formation of strong boards, there are no objectives to enhance the effectiveness in the CCM strategies and the managers of the companies are not motivated to achieve better results in the CCM;

- 1.2. the publication of vital information about the CCM is not sufficiently defined, which is why the information is provided inconveniently, at different places and fragmented – different information is provided about different CCMs;
 - 1.3. the CCM indicators analysis is not prepared to be summarized on the state level and the report of activities result is not prepared, which is why the possibility to objectively evaluate and compare the results on a country's scale and to spread the good practice is lost.
2. The municipalities do not periodically discuss the need to have controlled companies. About 10% of CCMs carry-out activities unrelated to the functions of municipalities. There is not enough initiative to optimize the CCM portfolio, which is why even if there are those CCMs, which carry-out similar activity, the municipalities establish joint ventures only in exceptional cases and even more seldom entrust the provision of public services function to the company, which is being controlled by another municipality.
 3. There is a popular view that a sole purpose of the CCM is meeting the public interest. Only financially capable CCMs can renew depreciated company assets, plan expansion, improve the quality of the provided services and reduce the price for consumers. However, the financial activity indicators of the CCM are poor:
 - 3.1. in the year of 2015, the return of the own equity of the portfolio was -0.42% (the average of Lithuania in 2015 was 9.2% ; state controlled companies – 4.4%);
 - 3.2. in the year of 2015, the return on assets was -0.18% (the average of Lithuania in 2015 was 6.4% ; state controlled companies – 2.5%);
 - 3.3. in the year of 2015, the net profitability was -0.69% (the average of Lithuania in 2015 was 5.2% ; state controlled companies – 10%);
 - 3.4. In the year of 2015, 34% of all CCMs made losses and 25% of all CCMs gained less than 15 thousand Euros of profit, which is why their financial sustainability may not be enough in the future in order to renew the depreciated company's assets, plan the expanse of the company, improve the quality of the provided services and reduce the price of them to the services consumers;
 - 3.5. small part of all CCMs generate a return for municipalities: 2% of controlled companies in the year of 2015 made 75% of all dividends and profit instalments. The total sum of the dividends and part of profit of the CCMs in the year of 2015 was 6.57 m Euros (if there would be an average 9.2% return on own equity norm in Lithuania, the likely net profit of these companies would be 115 M EUR). Which is why the municipalities do not use-up the possibilities to decrease the municipalities budgets deficit with dividends and profit instalments and to use them in implementing the municipalities' programs.
 4. The municipalities in comparison to the state often have more limited human and financial resources to implement the good governance practice, which is why it is very important for them to use the experience of the state in creating the guidelines of the CCM governance. A better CCM governance shall have a positive effect on the budget of municipality, form a positive society's opinion about the municipalities and the quality of services, help focus to achieve a more professional governance, better strategic planning and management, financial and social results, as well as the objectives of the municipalities.

RECOMMENDATIONS

To the Government of the Republic of Lithuania

1. By including the municipalities, to prepare and affirm the amendments of statutes of law regulating the CCMs by implementing in the implementation of property and non-monetary rights the principles applied by the state owned companies and the CCM governance guidelines (recommendations), to:
 - unify the CCM and property and non-monetary rights implementation in the state owned companies by adhering to the self-governance principles;
 - recommend for the municipalities how to differentiate commerce and non-commerce activities, form management bodies etc.;
 - define the publication of vital information about the CCM: in order to ensure the uniform spread of information, the municipalities should make public least of all information on CCM activities and results of the last three years;
 - evaluate periodic CCM necessity evaluation and criteria based on which the municipalities would carry-out the evaluation in order to be able to optimize the CCM portfolio and its management – to waive non-effective and non-necessary companies.

To the Ministry of Economy of the Republic of Lithuania

2. In order to achieve a greater publicity and transparency of the CCM activity, to discuss the possibility of entrusting the SE 'Turto bankas' (Governance Coordination Centre) with:
 - preparation of annual summarized analysis of CCM activity indicators;
 - provision of methodical help for municipalities on the issues of determining the objectives and indicators of companies, preparation of strategies, evaluation of pursuit of objectives, the selection of independent members of the management boards and on other issues related with the governance of companies;
 - preparation of form regarding the municipalities' publicized information on the activity and results of the CCM. The information should be provided in the same format benevolent for the analysis in order to compare the data.