



NATIONAL AUDIT
OFFICE OF LITHUANIA
• BRINGING BENEFITS •

GOVERNANCE OF STATE AND MUNICIPALLY OWNED ENTERPRISES AND PUBLIC BODIES

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SUMMARY

Relevance of the Audit

State and municipally owned enterprises operate in major sectors of the economy, contribute to economic growth, employment, supplement the budget with dividends and contributions, provide services important to businesses and citizens, ensure that the country's infrastructure promotes sustainable and long-term economic development by participating in the implementation of strategic projects. Effective governance of public bodies is also important for the implementation of educational, scientific, cultural, health, social and other activities that are beneficial to the society, as it creates economic value both for the organisations themselves and for the whole country, as well as benefits the society.

In 2017, we identified¹ that some state or municipally owned enterprises and public bodies do not add value to the state or municipalities; in some cases, they benefit only enterprises and public bodies themselves or even groups of private individuals.

With a view to joining the OECD and becoming a member of the OECD in 2018, Lithuania has actively improved the governance of the state and municipally owned enterprises in accordance with the guidelines and recommendations prepared by the OECD with a view to implementing the best international practices and principles of governance in managed enterprises. There are also negative trends in achieving ambitious targets or applying good governance principles. When the Seimas considered the amendments to

¹ Public audit reports: "Return of State-owned Enterprises to the State" No. VA-2017-P-20-3-10 of 25/04/2017; "Does the Governance of Municipality-owned Enterprises Ensure the Effective and Transparent Activity of the Enterprises" No. VA-2017-P-30-1-9 of 25/04/2017; "Does the Involvement of the State and Municipalities in the Management of Public Institutions Ensure the Benefit to the Society" No. VA-2017-P-10-9-11 of 25/04/2017.

the Law on Local Self-government of 2018, it did not approve the provisions proposed by the Government to assign municipalities to periodically assess the necessity of the municipally owned enterprises, while in 2019, the liberalisation of domestic transactions of municipalities was approved for the acquisition of services from enterprises owned by municipalities. In 2020, the target was to change the procedure of board composition – to reduce the number of independent members by replacing them with civil servants.

In order to assess whether the state and municipalities ensure that the activities of their owned enterprises and public bodies are based on the principles of good governance, are transparent, and oriented towards achievement of objectives; as well as the level of implementation of recommendations made by public auditors, we carried out an audit on the governance of state and municipally owned enterprises and public bodies.

Objective and Scope of the Audit

The objective of the audit is to assess whether the state and municipalities by participating in the governance of the state and municipally owned enterprises and public bodies ensure that their activities are based on the principles of good governance, are transparent, and oriented towards achievement of objectives.

Key audit questions

- whether legal regulation leads to clear governance of the participation of the state and municipalities in the activities of the state and municipally owned enterprises and bodies;
- whether the state and municipalities by participating in the activities of the state and municipally owned enterprises seek their effectiveness;
- whether the state and municipalities ensure transparency of activities of the state and municipally owned enterprises and bodies.

Audited entities:

- The Ministry of Economy and Innovation: forms a common management policy of state owned enterprises and state policy for the improvement of competitiveness in the areas of privatisation of state and municipal shares, exercises state property and non-property rights in the governance of state owned enterprises or public bodies;
- The Ministry of the Interior: forms the policy in the fields of public administration and public bodies, organises, coordinates and controls its implementation, exercises the property and non-property rights of the State in the governance of state owned enterprises or public bodies;
- Ministry of Finance, Ministry of Transport and Communications, and the Ministry of Agriculture have been selected as they exercise the property and non-property rights of the State in the governance of state owned enterprises or public bodies;
- administrations of the selected 8 municipalities of Kaunas City, Klaipėda City, Mažeikiai District, Panevėžys City, Šiauliai City, Telšiai District, Trakai District and Vilnius City, as they exercise the property and non-property rights of municipalities in the governance of enterprises or public bodies owned by municipalities.

We cooperated with representatives of the Association of Local Authorities in Lithuania and the Public Institution Governance Coordination Centre, which performs functions related to the implementation of the management policy of the state and municipally owned enterprises and their subsidiaries.

The audited period is 2017–2019, however, to assess the changes, we have also used data from previous years and 2020.

Limitations of the Audit

The analysis of financial indicators during the audit did not aim at assessing the result of each state or municipally owned enterprise or public body separately, as well as the performance of specific obligations was not eliminated or other individual peculiarities of managed enterprises or bodies.

The audit has been performed in accordance with the Public Auditing Requirements and International Standards of Supreme Audit Institutions. The scope and methods of the audit are described in greater detail in Annex 2, Audit Scope and Methods (p. 61).

Key Results of the Audit

By participating in the governance of managed enterprises and public bodies, the state and municipalities do not always ensure that their activities are based on the principles of good governance, are transparent, and oriented towards achievement of objectives. In 2020, there are still areas for improvement in defining the expediency of their establishment and fulfilling specific obligations, setting objectives for enterprises, formation of collegial bodies, and publishing information about enterprises and public bodies.

1. State and municipalities must participate in the management of enterprises and public bodies in a more targeted manner

Regulation of the expediency of an establishment of enterprises and public bodies and areas of their activities needs to be improved

The legal acts do not lay down detailed criteria for the establishment of state and municipally owned enterprises and public bodies, which was recommended by us in 2017.² Municipally owned enterprises operate in 24 different areas of activity, while state owned enterprises operate in 25. The scope of public services provided by public bodies and other functions assigned to them remains broad. Therefore, institutions and bodies representing the state or municipalities choose different legal forms when taking decisions to establish an enterprise, a company or a public body for the performance of the same or similar activities. Public bodies have lower governance standards compared to corporate governance (Sub-section 1.1, p. 14).

² Public audit reports: “Return of State-owned Enterprises to the State” No. VA-2017-P-20-3-10 of 25/04/2017; “Does the Governance of Municipality-owned Enterprises Ensure the Effective and Transparent Activity of the Enterprises” No. VA-2017-P-30-1-9 of 25/04/2017; “Does the Involvement of the State and Municipalities in the Management of Public Institutions Ensure the Benefit to the Society” No. VA-2017-P-10-9-11 of 25/04/2017.

Assessments of the expediency of participation in the activities of enterprises and public bodies do not ensure a significant change in their portfolios

By restructuring state owned enterprises, the Government sought to optimise the portfolio of state owned enterprises to 34 enterprises by the end of 2020, however, the deadline for the implementation has been postponed to 2024. At the end of 2020, there were 50 enterprises (118 in 2017) and less than half (10 out of 23) of measures related to the revision of the legal form of state enterprises (SE, Lith. VĮ), 11 (out of 37) measures were abandoned by decisions of the Government and the Seimas. As a result, the portfolio of state owned enterprises is not optimised as planned and in 17 state owned enterprises (of the legal form VĮ) whose legal form does not ensure smart governance the portfolio is still in force. Moreover, the Government does not sufficiently report to the Seimas about the progress of the restructuring of state owned enterprises. The report on its activities contains information and data on the portfolio of state owned enterprises only to the extent related to the decrease in the number of state owned enterprises during the restructuring process. As a result, the conditions for the Seimas and the Government to properly perform the functions of the owner of state assets assigned to them were not created (Sub-section 1.2, p.17).

In order to improve the governance of public sector bodies and to clarify their competencies, the state's representative authorities had to carry out their assessments in accordance with the Public Sector Improvement Guidelines. The assessments were assigned to enterprises (of the legal form VĮ) and bodies themselves; therefore, the validity of the functions performed by state owned enterprises and public bodies has not been objectively assessed. As a result, it is not possible to clarify their competencies, to review the network and content of service providers (health, education, social, cultural, etc.) and to determine which public services should be provided only by state enterprises or public bodies (Sub-section 1.2, p.17).

At least 75% (6 out of 8) of the audited municipalities carried out expediency assessments regarding participation in the activities of enterprises and public bodies owned by municipalities; however, this did not have a significant impact on the size of the portfolio of their enterprises and bodies (the portfolios of 8 municipalities decreased by 11%). Moreover, 9 municipal enterprises (of the legal form ME, Lith. SĮ) operated in these municipalities, and the institutions representing municipalities did not take the initiative to transform them into legal entities of other legal forms (AB or UAB). As a result, the portfolio of municipally owned enterprises has not been optimised and SĮ have not been restructured into legal entities of other legal forms, the governance of which is considered to be smart (Sub-section 1.2, p. 17).

Proper disclosure of specific obligations of state and municipally owned enterprises is not ensured

In their financial statements, state owned enterprises lacked a methodology for proper disclosure of their specific obligations (non-commercial functions) assigned to them. 59% (10 out of 17) of the assessed state owned enterprises have not properly separated the specific obligations from other activities. As a result, 55% (6 of 11) of them used cross-subsidisation: the costs of the specific obligations were covered by revenues from commercial activities or at the expense of other specific obligations. Due to the peculiarities of self-government legal regulation, municipally owned enterprises were unable to implement the recommendations and separate specific obligations (non-commercial functions), although 17% of (11 out of 63) enterprises assessed performed

functions that had specific characteristics, such as reduced passenger transport. Without separation between commercial and non-commercial functions, the managed enterprises cannot objectively assess the costs of the specific obligations entrusted to them, and the institutions representing the state and the municipalities lack information on their impact on enterprises' profitability and expected return (Sub-section 1.3, p. 24).

2. By participating in the activities of enterprises, the state and municipalities take measures to increase their efficiency, which is lacked in the governance of public bodies

Financial expectations in full have been set for 32% of state owned enterprises and for 18% of municipally owned enterprises

The audited institutions representing the state and municipalities set non-financial expectations in performance expectations for all state and municipally owned enterprises, and the financial expectations were fully set for 32% (12 out of 38) of enterprises owned by the state and for 18% (9 out of 50) of enterprises owned by municipalities. Public bodies, institutions representing the state and municipalities, are not be obliged to prepare them. In accordance with the performance expectations, the enterprise should prepare its strategy, however, only 47% (18 out of 38) of assessed state owned enterprises and 39% (15 out of 39) of enterprises owned by municipalities included all recommended financial expectations into their strategies, accordingly, non-financial expectations were included by 21% (8 out of 38) of state owned enterprises and by 21% (9 out of 42) of municipally owned enterprises. Without established expectations, the clear needs of institutions representing the state and municipalities are not defined, and it is not encouraged to seek better performance indicators. In addition, their performance strategies may not meet the owner's needs (Sub-section 2.1, p. 27).

The return of all assessed state and municipally owned enterprises to the state has been in accordance with their long-term plans, while the return of 43% of enterprises to municipalities was not in line with their long-term plans

84% of the assessed dividends or profit contributions of the enterprises owned by municipalities did not allocate or allocated fewer dividends into municipal budgets than they could in accordance with the good practice of state owned enterprises. This is influenced by the fact that the policy on the allocation and payment of dividends by municipally owned enterprises, contrary to state owned enterprises, is not regulated by legal acts, the municipality itself decides on the allocation of dividends. Some of them carried forward the profit available for distribution without linking it to long-term investments of enterprises. In 2019 alone, 43% of the assessed municipally owned enterprises carried forward EUR 17.5 million of profits available for distribution, whereas 60%–85%, i.e. from EUR 10.5 million to 14.8 million (taking into account the return on equity) of which could have been paid into municipal budgets. In this way, municipalities could allocate them to social needs, health care, education, etc. (Sub-section 2.3, p. 35).

Formation of collegial bodies of enterprises should be improved, while the principles of good governance have not been implemented in public bodies

In order to ensure that the collegial bodies are formed of competent and motivated members and that their selection process is transparent, the formation of collegial bodies should be improved as:

- all institutions representing the state (5) and municipalities (8) do not establish qualification (special) requirements before taking a decision to appoint a dependent member of the collegial body. Such appointment is not transparent and increases the risk of selection of incompetent members (Sub-section 2.5, p. 39);
- The legislation does not provide for any other persons appointed by the entity initiating the selection to the collegial bodies of the managed enterprises, without selection procedure, which does not correspond to the principle of transparent formation of collegial bodies (Sub-section 2.5, p. 39);
- In the collegial bodies of 30% (16 out of 53) of assessed enterprises owned by municipalities, there were fewer independent members than established, whereas in the enterprises owned by the state such cases are rare (3 out of 29). In addition, there were no independent members in the collegial bodies of 77% (17 out of 22) of subsidiaries of state owned enterprises and 22% (12 out of 53) of municipally owned enterprises. As a result, one of the fundamental principles of corporate governance, namely the independence of collegial bodies, is not ensured (Sub-section 2.5, p. 39);
- In the assessed enterprises owned by the State (29) and municipalities (36), the fixed remuneration system applies to 23% of state owned enterprises and 61% of municipally owned enterprises. In other cases, other systems are applicable: payments for meetings or hourly rates or a mixed rate is applied, which does not correspond to the international good practice and does not ensure the recruitment of competent and motivated collegial bodies (Sub-section 2.5, p. 39).

Formation of collegial bodies of state and municipal public bodies and requirements for their members and legal acts are not regulated. There were cases when the principles of good governance were implemented; for example, the articles of association of 20% (7 out of 35) of assessed public bodies aimed at recruiting independent members and in 5 out of those established the independence requirements. The absence of good governance principles does not allow for the formation of strong collegial bodies contributing to better results (Sub-section 2.5, p. 39).

3. Transparency requirements for publicity of state and municipally owned enterprises and public bodies differ

Generalised information on the performance results of enterprises is published, whereas information on the enterprises without the majority vote and public bodies is not published.

Since 2020, the Government has commissioned the Ministry of the Interior to analyse and assess national data on public bodies in which the state or municipalities participate, however, the content of the analysis was not specified. Therefore, there are no centralised public data relevant for shaping the policy of state and municipally owned public bodies, how many and which public bodies carry out activities, what their functions and performance indicators are. Moreover, no entity is assigned to analyse and publish information about participation in the activities of enterprises in which the State or municipalities participate without a majority vote. In 2019, there were 23 such enterprises; they paid to the state and municipalities EUR 68 thousand of dividends, ministries and municipalities transferred them assets (of the value of EUR 1.7 million), etc. As a result,

the full scope of participation in the activities of enterprises and the resulting benefits are not known (Sub-section 3.1, p. 51).

24% of assessed enterprises did not disclose the information about the received support, and there are no publicity requirements for public bodies

State and municipally owned enterprises (of the legal form VJ) cannot provide support; this is allowed for enterprises and public bodies. State and municipally owned enterprises are obliged to publish information on the received support on their websites, whereas public bodies – not. A total of 6 state and 50 municipally owned enterprises and 16 public bodies owned or jointly owned by the State or municipalities provided support annually in 2017–2019. In 2017–2019, 24% of assessed enterprises (8 out of 33) did not disclose information about the received support; they did not disclose the information on the received support amounting to around EUR 804.6 thousand. This does not allow each member of the public to assess the relevance of the support granted (Sub-section 3.2, p. 53).

Recommendations

To the Government

1. In order to ensure that state or municipally owned bodies in accordance with the activities carried out could choose the most appropriate legal form of a legal entity which would enable to achieve the best results in its governance, the legal acts should lay down detailed establishment criteria for the selection of the legal form of a legal entity (1 key audit result).
2. In order to ensure that only state owned enterprises whose functions are important for the fulfilment of the objectives of the state would operate, it is necessary to ensure that measures concerning the optimisation of the portfolio of state owned enterprises are implemented (1 key audit result).
3. In order to reduce the number of state owned enterprises (VJ) of a non-innovative legal form, provide for measures to restructure them into legal entities of other legal forms (1 key audit result).

For the Ministry of Economy and Innovation

4. In order to facilitate and assist the disclosure of commercial and non-commercial functions by municipally owned enterprises, it is needed to initiate amendments to the legislation on the appropriate identification of these functions (1 key audit result).
5. In order to strengthen the selection of collegial bodies, the measures to increase the transparency of the selection procedures for the members of the collegial bodies need to be implemented (2 key audit result).
6. In order to ensure that the remuneration policy of the members of collegial bodies of state and municipally owned enterprises is in line with international good practice, the remuneration policy for members of the collegial bodies by providing for a fixed remuneration system needs to be updated (2 key audit result).

To the Ministry of Interior

7. In order to ensure that the governance of public bodies owned by the state or municipalities conforms to the principles of good governance and is oriented to their effective and transparent activities, amendments to legal acts regarding the principles of good governance (establishment of objectives, formation of collegial bodies and publicity of the granted support) in public bodies need to be initiated (2 and 3 key audit results).
8. In order to gather comprehensive data enabling decision making in shaping the policy of state and municipally owned public bodies, it is needed to determine what data on these bodies should be assessed at national level and disclose them (3 key audit result).
9. In order to enable the implementation of the Public Sector Improvement Guidelines to facilitate the clarification of functions of state owned enterprises (of the legal form VJ) and functions of public bodies, state representative institutions must initiate re-assessments of the compliance of the state owned enterprises and public bodies to the Guidelines; and to inform the Government on the compliance results for the decision making (1 key audit result).

To the Governance Coordination Centre

10. In order to gather and disclose the information on all enterprises in which the state and municipalities participate, the information on the enterprises which do not have a majority vote should be disclosed (1 key audit result).
11. In order to facilitate the establishment of the objectives pursued by the state and municipalities for managed enterprises, the methodological support measures which would facilitate the institutions representing the state and municipalities to ensure the quality of prepared performance expectations should be implemented (2 key audit result).

Recommendations to institutions representing municipalities

In order that municipalities by participating in the governance of enterprises and public bodies owned by them ensure that their activities are based on the principles of good governance, are transparent, and oriented towards achievements of objectives, we recommend to municipalities:

- periodically assess the need for the relevance of the implementation of managed enterprises or functions assigned to them and to abandon the non-innovative legal form of municipally owned enterprises;
- evaluate the expediency of participation in the activities of public bodies seeking to ascertain whether the activities carried out are related to the implementation of the functions assigned to municipalities;
- approve policies for the allocation and payment of dividends of companies owned by municipalities and to carry out the monitoring of their implementation;
- assess the volume of internal transactions with owned enterprises where the relevant services can be purchased from private suppliers through competitive procedures;

- strengthen the formation of collegial bodies by including as many independent members of collegial bodies as required by legislation;
- initiate the strengthening of internal control procedures for declaring private interests of members of collegial bodies and providing information about these bodies on websites.

In order to increase the impact of the audit, we informed the audited institutions representing the state and municipalities, audited municipal control and audit services and the Association of Local Authorities in Lithuania of the audit results.

Measures and deadlines for the implementation of recommendations are provided in the Section Recommendation Implementation Plan of the Report (p. 57).