Participation of rural municipalities and cities in companies and foundations

National Audit Office's report to the Riigikogu, Tallinn, 2 July 2010

Are local authorities using the means granted by law to guarantee public interests when participating in companies and foundations?

Summary of audit results

The National Audit Office audited 17 companies and foundations controlled by local authorities to identify how the rural municipality or city uses the means granted by law to exercise their interests in the company and how the company's directing bodies are used for his purpose. We also identified the reasons why a rural municipality or city participates in a company, which is why we also audited 15 rural municipalities or cities that are the owners or founders of said companies.

The audit assessed the performance of the obligations and exercise of the rights arising from law at the different management levels of a company, i.e. the activities of the company's management board, supervisory board and local government bodies that represents the interests of the owner in the company. Information was gathered for the period from January 2007 to June 2009.

The number of companies and foundations operating under the control of local authorities is rather high: approximately 380 in April 2010. It is considerably higher than the number of local authorities. Since some service important for the local community is usually provided via such companies, the interest of local residents calls for sustainable management of such companies. Moreover, cases where the activities of the company are financed largely from the rural municipality or city budget, that is, where the tax revenue is used for management of the company, are not rare.

The opportunity of rural municipality and city leaders to interfere with the activities of the companies or foundations is much more limited than the possibility to organise the work of the local authority. A company is an independent economic entity whose management is subject to its own rules that have to be followed. Local authority leaders have to understand this in order to achieve control over the activities of the company using lawful means and hedge the risks that threaten the public interests related to the company in the best possible manner.

According to the National Audit Office, local authorities have not always established goals for participating in the audited companies and foundations. There are serious shortcomings in the organisation of management in the audited companies and the National Audit Office finds that public interests are not well protected in companies where local authorities have a shareholding. The obligations of the management bodies of companies stipulated by law were often not observed, and the rights granted to local authorities as the owners for management and supervision of the activities of companies were also not regularly exercised.

The division of the legal roles of the management board or supervisory board of the company and the rural municipality or city government is often considered a formality that is not overly important in the management of the company. The desire of local government leaders to interfere in the activities of companies for the purposes of more efficient supervision with methods that are appropriate for coordination of the activities of the administered agency, which manifests itself from time to time, does not comply with the principles of company management and does not make up for the shortcomings in the activities of directing bodies. If the directing bodies do not perform their functions, there is a real risk that important changes in the financial position of the company will not receive the required attention and the company may run into economic difficulties. Evidence of this was found in the course of the audit.

The opinion of the National Audit Office is that above all, supervisory boards are the directing bodies that should live up to their role in municipal companies, as in essence, their duty is to exercise supervision over the lawfulness of the activities of the company and fulfilment of the objectives established for the management board. Unfortunately, supervisory boards are often formed on political grounds and their members do not possess sufficient professional skills for inspecting the management board. Unlike the collective political responsibility of a council or government member, failure to perform the obligations of a member of a directing body of a company may lead to personal material liability.

The opinion of the National Audit Office is supported by the following generalisations:

■ **The reason why a local government has a holding in a company is often unclear.** Local authorities should participate in companies in consideration of the duties that local authorities are required to perform by law. The audited local authorities had mostly not determined why participation in a company is important for the local government, and they were often unable to justify why they had decided to establish a company in the first place.

Provision of public services in the best possible manner is often not the weightiest argument in favour of the creation of a company. Many audited local authorities had established companies because they wanted to borrow money for the development of the rural municipality or city through the company without increasing the loan burden of the local government.

■ **Local authorities often have not set sufficient goals for the activities of companies.** The performance of companies and the need to continue participating in them is not often discussed by decision-makers. The National Audit Office ascertained that local authorities had set measurable goals to only a few of the audited companies. The National Audit Office also found that councils, which have the right to decide whether or not participation in a company will continue, are not sufficiently informed about the activities of the companies and the performance of companies or the need to continue participating in them is often not discussed in councils.

■ **Informing the supervisory board of a company and the rural municipality or city government of the company's economic status is poorly organised.** The supervisory boards of five companies had not been informed of the company’s economic status at the frequency stipulated by law. In nine companies, members of the supervisory board were not aware of significant changes in the company’s financial position (e.g. deterioration of solvency) and four companies had not called a general meeting of shareholders after a serious decrease in assets, even though this is required by law.

■ **Use of the supervision options granted by law is passive.** The supervisory boards of companies as well as rural municipality and city governments have been passive in the use of the options offered by law for inspecting the activities of companies. Supervisory boards have usually not inspected the companies’ accounting documents, the existence of their assets, the lawfulness of the activities of management boards, etc., or reviewed the documents of the companies. Most rural municipality and city governments have also not checked documents, even though the law gives them the right to do so.

■ **Management board and supervisory board members have made decisions in issues that should be decided by higher-ranked directing bodies.** The management boards of four companies had concluded transactions that are not within the scope of the company's everyday activities without the supervisory board's consent. There was no understanding in many companies of which transactions do and which do not fall into this category.

In five companies, the remuneration of management board members had in some cases been paid without the decision of a higher-ranked directing body.

Companies in which local authorities participate should also acknowledge the threats associated with conflicts of interest. The National Audit Office ascertained that ten of the audited companies had concluded transactions with management board members or with other companies associated with management or supervisory board members. The fact that such transactions had been concluded in so many audited companies points out that there is a real risk of conflicts of interest in companies. In three of the companies we audited, management board members had breached the Anti-corruption Act in the conclusion of transactions.

In the opinion of the National Audit Office these figures mean that supervision of the activities of the management bodies of local government companies is unjustifiably weak.

■ **There are organisational shortcomings in the work of supervisory boards.** The supervisory boards of four companies had not held meetings at the frequency stipulated by law or in the articles of association. Also, supervisory board meetings had not been appropriately documented in many companies: in five companies, the discussion of all important issues was not recorded in the minutes and in four companies, minutes had not always been signed by all the supervisory board members who attended them.

Responses of auditees

As a result of the audit, the National Audit Office made eight recommendations to rural municipality or city governments, or rural municipality or city councils in 13 of the audited local authorities. The National Audit Office also made a recommendation to the supervisory boards of 11 of the audited companies or foundations, and recommendations to the minister of regional affairs and the minister of finance.

Approximately two-thirds of the auditees said that they intended to implement the recommendations in full or in part. Some of the auditees (approximately one-fifth) will decide on their standpoint towards the recommendations at the next council or government sessions, which will generally be held in August and September 2010.

The Minister of Regional Affairs did not agree to follow the National Audit Office's recommendation to initiate a discussion involving various stakeholders in order to identify whether it is necessary to amend the legislation regulating participation in municipal legal persons in private law. The Minister found that the legislation in force gives local authorities sufficient means for exercising their interests in various companies. However, he did admit that the awareness of local government officials of these means should be better, which is why they need additional training and instruction. The minister of regional affairs also said that he is prepared to participate in the training and instruction process.

The Minister of Finance did not agree with the National Audit Office's recommendation to harmonise the options of conducting special audits in legal entities in private law in which local authorities participate by granting the right to conduct special audits to the internal auditor of the local government similarly to the internal control unit of the ministry. The

National Audit Office still believes that differences in how special audits are conducted in companies of state government and local authorities are not justified.

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